MODULE 25

24 The Multiplier

25 Consumption and Investment Spending

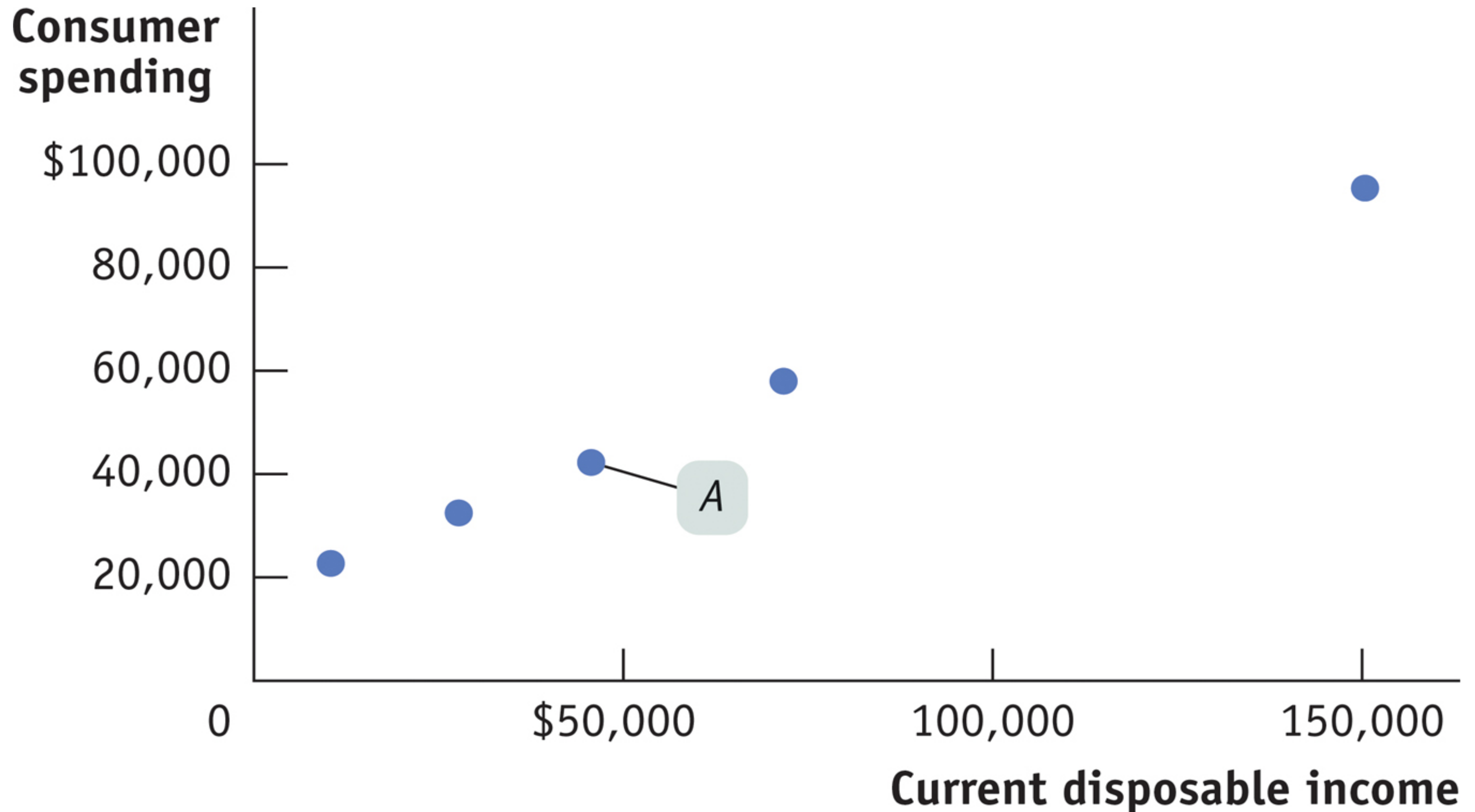
26 The Income-Expenditure Model

Consumer Spending

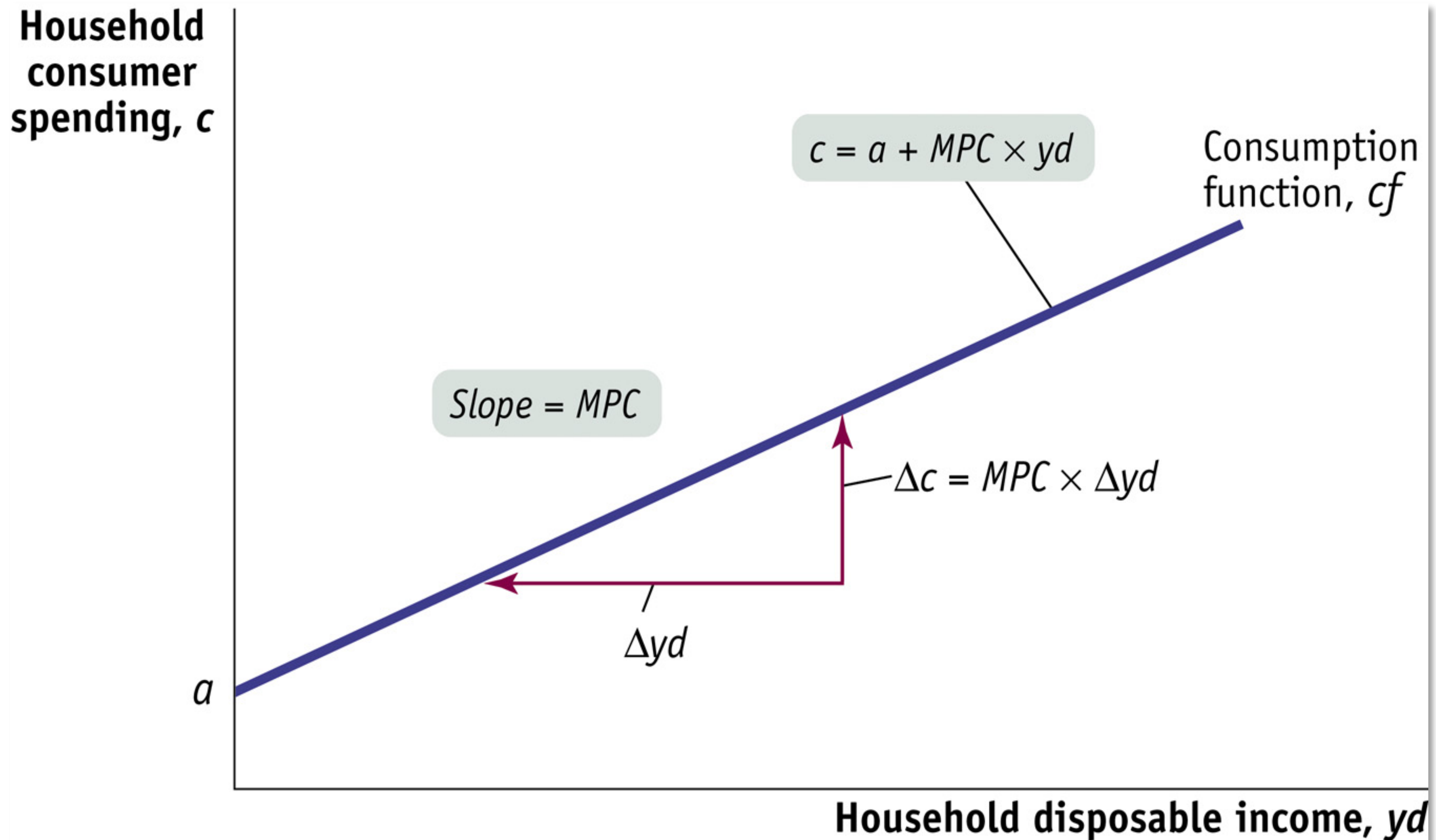
- The **consumption function** is an equation showing how an individual household's consumer spending varies with the household's current disposable income.

$$c = a + MPC \times yd$$

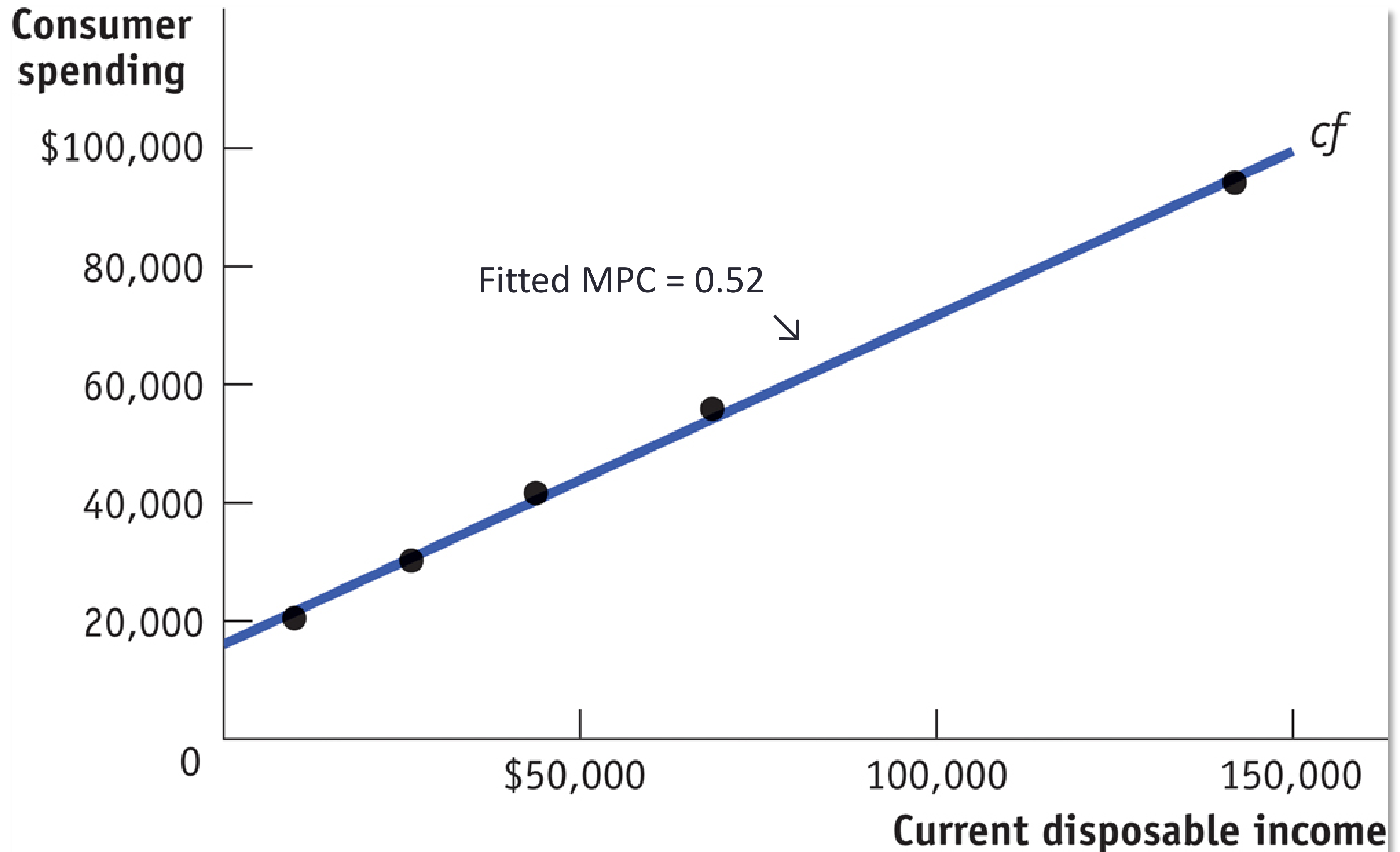
Disposable Income & Consumer Spending



The Consumption Function



A Consumption Function Fit to Data

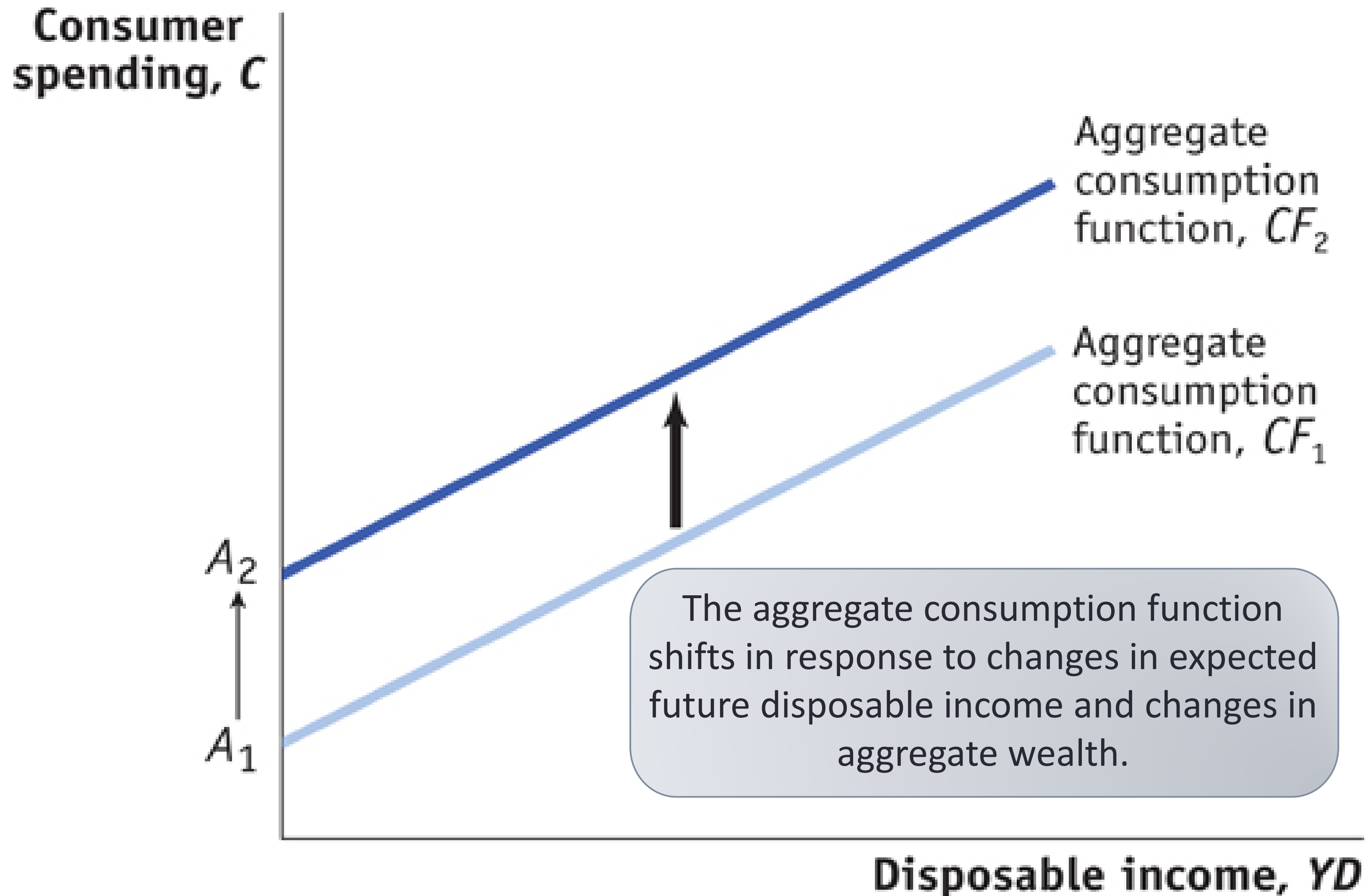


Shifts of the Consumption Function

- The **aggregate consumption function** is the relationship for the economy as a whole between aggregate current disposable income and aggregate consumer spending.

- Shifts in the aggregate consumption function can occur because of
  - Changes in expected future disposable income
  - Changes in aggregate wealth

Shifts of the Consumption Function



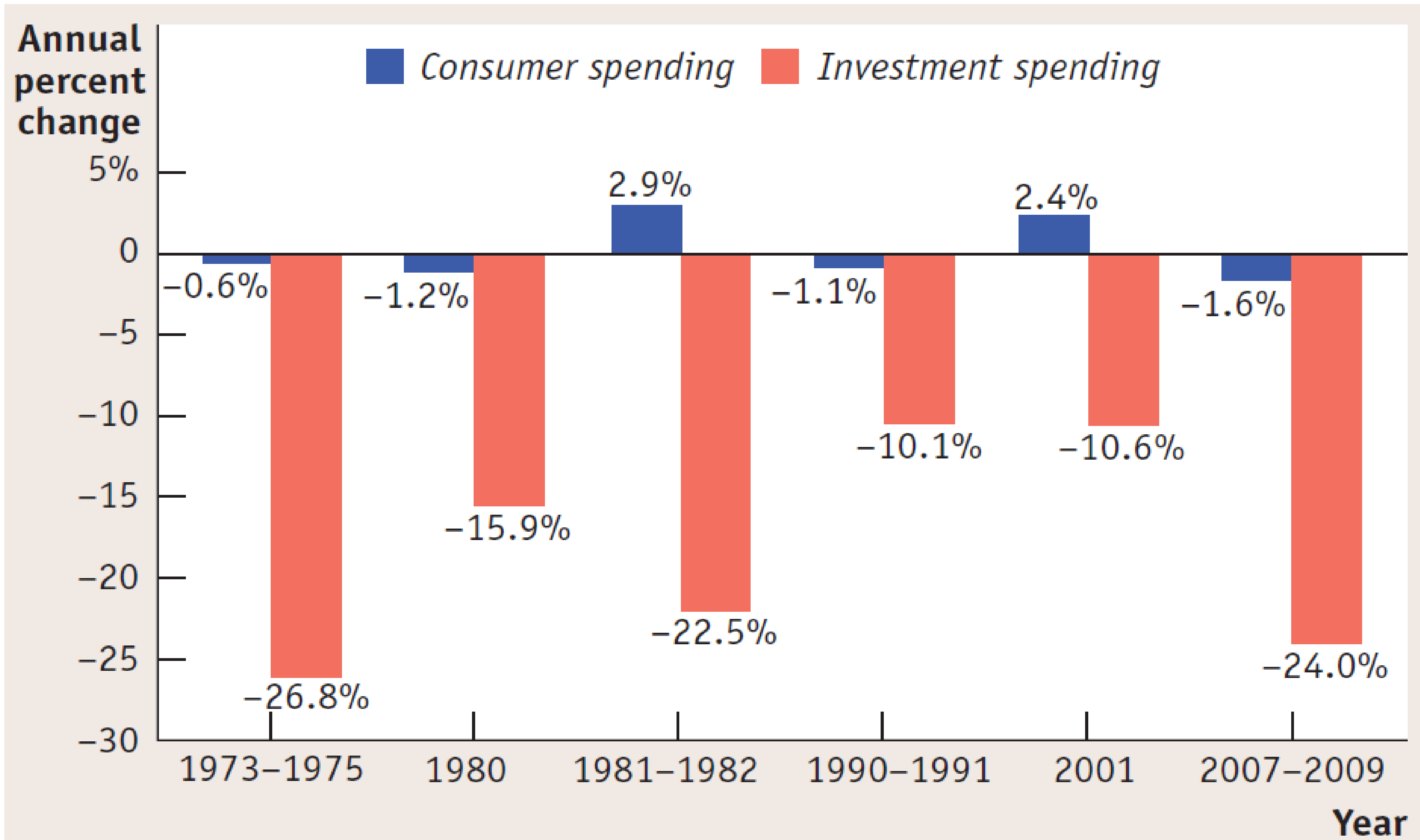
Investment Spending

- **Planned investment spending** is the investment spending that businesses plan to undertake during a given period.

- It depends **negatively** on the:
  - *interest rate*
  - *existing production capacity*

- and **positively** on:
  - *expected future real GDP*

Fluctuations in Investment and Consumption



The Interest Rate and Investment Spending

- Planned investment spending is negatively related to the interest rate
- Spending on residential construction will decline as interest rates increase
- Businesses will find fewer investment projects profitable as interest rates increase

Inventories and Unplanned Investment

- **Actual investment spending** is the sum of planned investment spending and unplanned inventory investment.
- **Unplanned inventory investment** occurs when actual sales are more or less than businesses expected, leading to unplanned changes in inventories.

$$I = I_{Unplanned} + I_{Planned}$$

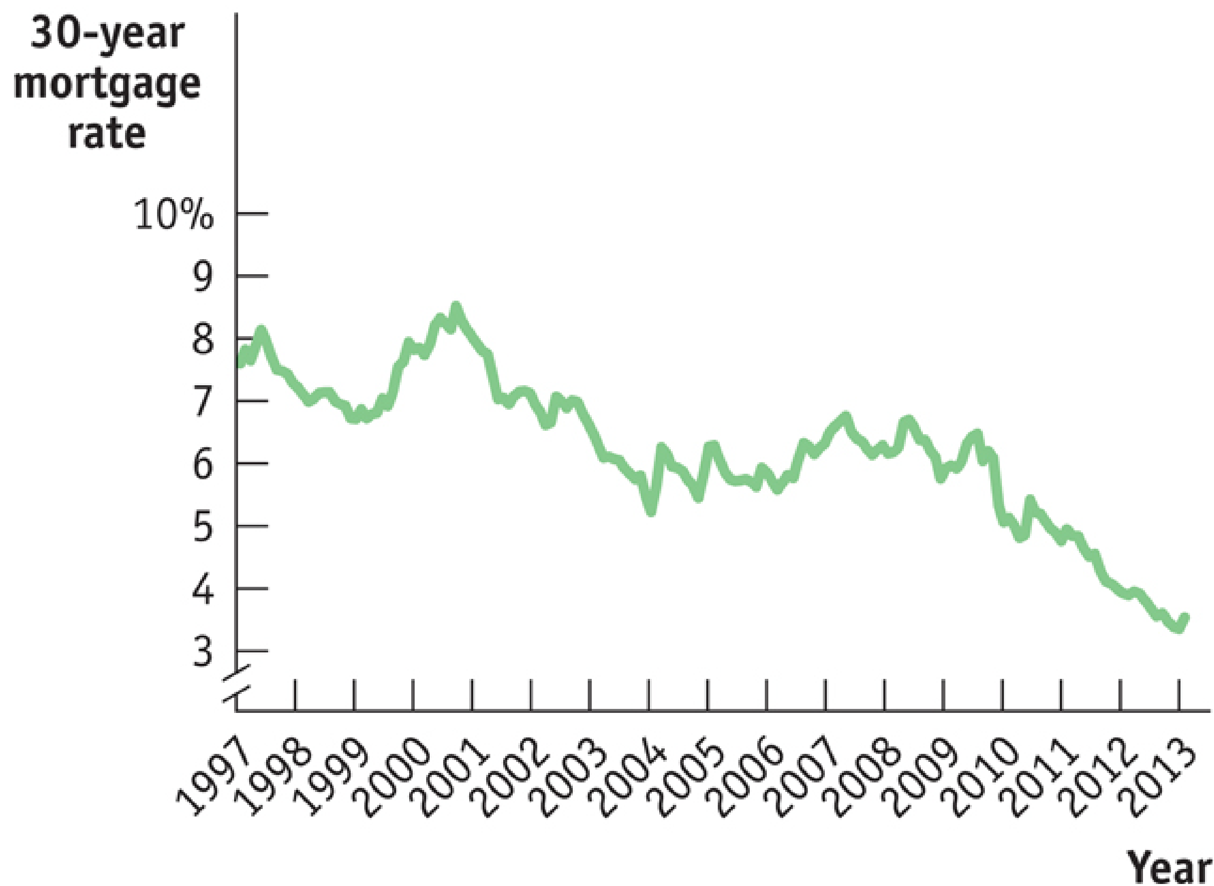
Economics in Action

Interest Rates and the U.S. Housing Boom

- The Fed cut mortgage rates in response to the 2001 recession and continued cutting them into 2003 out of concern that the economy's recovery was too weak to generate sustained job growth.
- The low interest rates led to a large increase in residential investment spending, reflected in a surge of housing starts.
- By 2006, it was clear that the U.S. housing market was experiencing a bubble: people were buying housing based on unrealistic expectations about future price increases.
- When the bubble burst, housing—and the U.S. economy—took a fall.

Economics in Action

Interest Rates and the U.S. Housing Boom



Economics in Action

Interest Rates and the U.S. Housing Boom