SIMPLE KEYNESIAN MODEL OF INCOME DETERMINATION: SAVING-INVESTMENT APPROACH

According to Keynes a part of the income is used on consumption expenditure and the remaining part is saving. When all the individuals saved then we get total saving in the economy. Wealth that is created by humans from which the which the flow of goods and services or utility takes place is called capital. The addition to the stock of capital is called investment.

Regarding saving and investment there are two concepts

- Saving is always equal to investment
- Saving and investment are equal only in equilibrium.

The concept of saving to be equal to investment was followed by the classical economists. They believed saving will be equal to investment due to the free market forces.

Real saving/ real investment is the saving /investment which has already happened, planned saving/ planned investment is the saving/ investment which the individual hasn't done but plan to realize it.

Real saving is always equal real investment. If the real saving increases then the consumption expenditure decreases. As the consumption expenditure has decreased it will increase the stock of capital (form of investment). Therefore, the real saving increases then the real investment increases as well and vice versa.

Planned saving is not equal to planned investment. Keynes believed that planned saving can be equal to planned investment only during equilibrium as the individuals who are saving (household) are different from those individuals who are investing (producers) and their objectives are different.

So real saving is always equal to real investment but the planned saving is equal to planned investment in equilibrium.

Equilibrium level of national income in the saving-investment approach occurs when the saving is equal to investment. It is assumed that the total saving of the country depends on the income of the country.

$$S = S(Y)$$

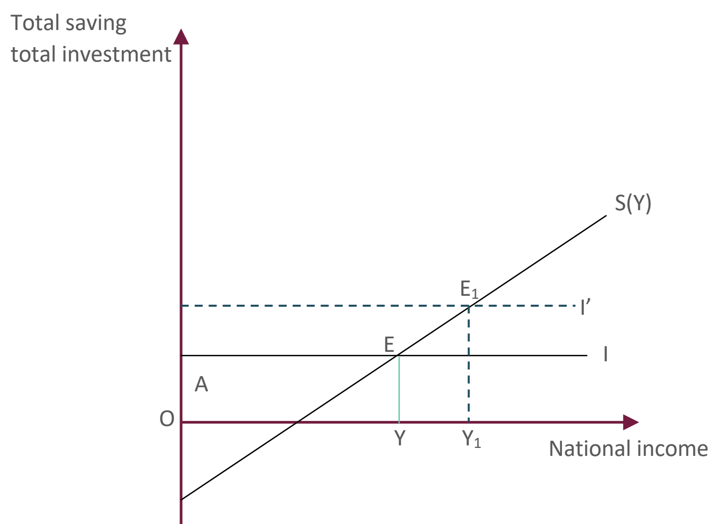
The level of investment is autonomous and is given by

$$I = A$$

The equilibrium condition to determine national income is

$$\text{saving} = \text{investment}$$

$$S(Y) = A$$



Saving function is an upward sloping function and It intersects with the investment curve at point E and the equilibrium level of nation income is OY. When there is deviation from equilibrium, the tendency to move towards the equilibrium and come back to equilibrium is called stable equilibrium.

If saving is greater than investment then,

$$S > I$$

$$\Rightarrow Y - C > I$$

$$\Rightarrow Y > C + I$$

This shows that the total supply of goods and services is greater than the total demand of goods and services. This will result in the increase in stock of inventory so the production will decrease. When output decreases it means that the national income decreases till the equilibrium is reached.

Equilibrium level of national income changes when the level of investment changes. When there is an increase in the investment the equilibrium shifts to E_1 and the new equilibrium level of national income will be OY_1.