

Short-term equilibrium is reached in the economy when aggregate demand corresponds to total production by companies at the given price level, i.e. when:

$$(14.3) Y = AD$$

Equilibrium is reached when there are no unintended changes in inventories ($\Delta \text{inventories} = 0$). This means that investments consist only of those that are planned.¹¹⁴

But what determines planned demand AD? For the sake of clarity, it is best to start by ignoring the public sector and the rest of the world. In this scenario, equilibrium is when:

$$(14.4) Y = C + I$$

This corresponds to the simple economic cycle illustrated in Figure 12.2 in Chapter 12, and which is repeated again as Figure 14.2 below.

14.1.1 Consumer spending

Consumer spending makes up a very large proportion of national income. In 2013, consumer spending¹¹⁵ was DKK 920.4 billion out of a total GDP of DKK 1,886.4 billion, i.e. 49%.

The marginal propensity to consume and the marginal propensity to save

The starting point for household consumption is income. The greater the household income, the more households will wish to spend. Household consumption C can be written as:

$$(14.5) C = C_0 + c \cdot Y$$

114 The economy may, however, still be out of balance for a period, e.g. if planned demand exceeds production. In this situation, companies will eat into their stocks to meet the strong demand. Inventory levels will fall. Conversely, stocks will build up if the projected demand is less than production, as companies will stockpile goods they are unable to offload.

115 Consumer spending by households and NPISH.

where Y is income, C_0 is the proportion of household consumption that is **independent** on income, and c is the marginal propensity to consume, which shows how much of any rise in income the household will spend. If, for example, the marginal propensity to consume is 0.8, this means that when income rises by DKK 1, household consumption rises by DKK 0.80. The remainder goes into savings.

Using Δ to mean “the change in” (in consumer spending and income, respectively), the marginal propensity to consume c can be written as:

$$(14.6) \quad c = \Delta C / \Delta Y$$

The proportion of the extra earnings that households save is called the marginal propensity to save s . The marginal propensity to save is:

$$(14.7) \quad s = \Delta S / \Delta Y$$

Since rises in income are divided between higher spending and higher savings, the sum of the marginal propensity to consume and the marginal propensity to save is 1. In other words, $c + s = 1$.

The marginal propensity to consume is illustrated in Figure 14.1. Note that when households earn one extra krone, they will spend the share c of this increase. The marginal propensity to consume therefore corresponds to the slope on the curve.