Relationship between Consumption and Permanent Income

According to permanent income hypothesis, Friedman thinks that consumption is proportional to permanent income

 $C^{P}=kY^{P}$

where Y^P is the permanent income C^P is the permanent consumption k is the proportion of permanent income that is consumed.

The proportion or fraction k of permanent income that is consumed depends upon the following factors: rate of interest (i), rates of property and non -property income to total wealth or national income (**w**) and consumers propensity to consume (u).

Thus rewriting the consumption function based on Friedman's permanent income hypothesis we have

$$C^{P} = k(i, w, u) Y^{P}$$

Friedman's permanent income hypothesis is illustrated in Figure below. It is seen from the figure that permanent consumption function is represented by the long-run consumption function curve C_{LR} , $(C_{LR} = kY^p)$. This long-run consumption function shows the performance relationship between consumption and income and is a straight line parsing through the origin which implies that APC is constant and is equal to MPC.



Friedman also supposes that the permanent and transitory components of income and consumption are uncorrelated.

Thus

- 1. $ry_p y_t = 0$ there is no correlation between transitory and permanent income.
- 2. $rc_pc_t = 0$ there is no correlation between permanent and transitory
- 3. $ry_tc_t = 0$ there is no correlation between transitory income and transitory consumption.

A basis argument of Friedman's permanent income hypothesis is that transitory income and transitory consumption are not correlated. It amounts to saying that in a period in which a family's measured income contains a negative transitory component, it will not result in a