EC1506 Course Assignment- Essay

1. The recent economic climate resulted in a decline in business and consumer confidence in the UK economy, leading many households to increase their level of savings. Do you agree that an increase in savings will lead to an increase in the level of investment expenditure in the economy? Explain your answer using relevant economic theory.

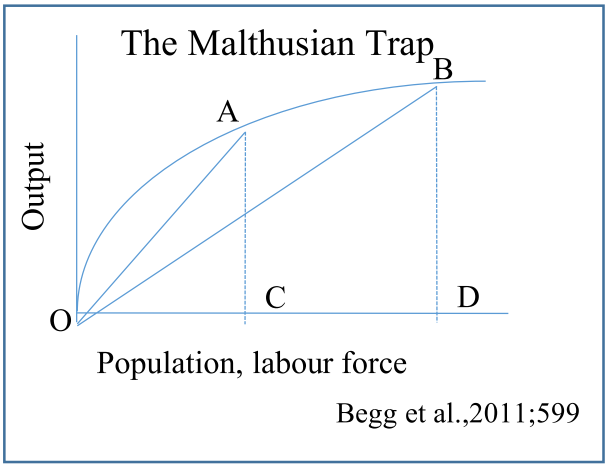
With the recent worries on world economy, the future is a big question mark for many. For example, China's annual GDP growth of 6.9% is the lowest it has been since 1990 (Wildau and Mitchell, 2016). These concerns have reached the UK, where consumer confidence has dropped from 4 in January 2016 to 0 in February 2016(TE, 2016). With these figures, households are likely to save more rather than invest and borrow. Will saving increase the level of investment expenditure? In this essay I will tackle this question using the Keynesian economic theory and the Malthusian theory.

First I will analyse the subject from a Keynesian point of view. Through methods of substitution (Parkin et al., 2011;538), we find that I = S + (T-G) + (M-X), where I is investment, S is savings, T is taxes, G is government expenditure, M is imports and X is exports. Therefore, "Investment is financed by household savings, the government budget surplus and borrowing from the rest of the world" (Parkin et al., 2011; 538). However, this identity takes into account stock building (inventory accumulation), which does not increase the actual investment into machinery and the likes. Stock building can lead to a recession due to unconsumed products, and eventually lay-offs, non profitability and inefficiency. In this situation, firms must get rid of excess products and correlate their supply with changed demands. This difference in supply and demand is what Malthus called gluts. Fortunately, use of lean production helps decrease these effects. Proper forecasting the demand for goods and services also helps to reduce accumulating inventory.

If firms do not change according to demand and lower output, real GDP falls and price levels increase (Parkin et al.,2011;618). It can make recession worse as aggregate demand and economic growth decrease. The marginal propensity to save of households also decreases and cuts the multiplier effect. On the other hand, there are positive aspects to increased saving as well. Saving lowers demand for loanable funds and therefore lowers interest rates. The central bank would probably also lower the interest rate with expansionary monetary policy to promote investing and spending. Lower interest rates allow an increase in lending, which is beneficial for monetary financial institutions and promotes economic activity. Asset prices can also increase, and uneconomic investments could become profitable. These effects will only happen once saving has begun and interest rates have already dropped. Extended periods of low interest rates can be problematic. It is, after all, one of the main reasons for the 2008 financial crisis. It drives the people into a limbo where they want to save, yet they do not get much return for their savings. It can also lead companies that require profitability of money-market funds to bankruptcy (Kliesen, 2011).

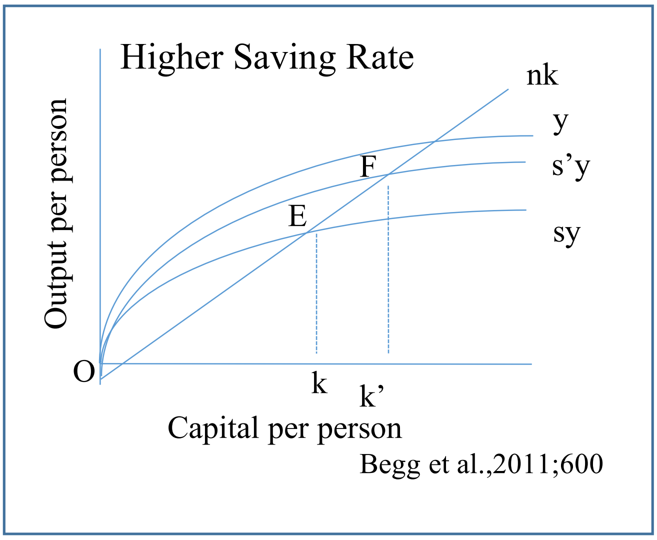
The big question on saving is the paradox of thrift. John Keynes believed that it is better for the government to spend money to create jobs, rather than make workers save and eventually create unemployment. The problem with Keynes' view is that when the government makes a deficit, it must sack the people it employed. This lowers output which in turn leads into many other problems. Essentially, if the government cannot stabilize the jobs it creates it can make unemployment worse than before. Keynes solved this problem with government spending, with increased taxes when the economy was ready (at the cost of government deficit spending) (Posner, 2009). All in all, it is a solid plan, yet the difficult part is making people pay the taxes. At least they are not saving money. The paradox makes a full circle if people continue saving, their income becomes lower so even if the marginal to propensity to save is higher than before, total savings are equal if not lower (Posner 2009). As savings equals investment, it is up to mostly the government to decide what happens to the UK investment expenditure once savings increase.

Now I will look at the Malthusian point of view, firstly the Malthusian trap. As the labour force grows with population, there are diminishing returns to output (Begg et al.,2011;599). The figure below shows this:



When the labour force is at C, the slope of the curve OA shows the output per worker. At population D the output per worker has decreased. This suggests that eventually output per worker decreases until the economy cannot support growth and it begins to falter.

The effect of diminishing returns on output per worker is important, as it needs to be avoided. One way to accomplish this is to increase investment per person when the population growth is faster, alongside with higher capital per person (Begg et al.,2011;600). However, the increase of capital per worker also comes with diminishing returns.



S = savings
k= Capital per person
sy = investment per person
nk = Capital per person needed to keep k constant

This graph shows how capital per person and output change when savings increase from s to s'. Capital per person, output per person and investment per person increase.

The economy always converges to a steady state (E or F) if the investment per person is too high or low compared to the capital per person. However, even with the changes in saving and investment, the function of growth and accumulation Y = A x f(K,L) (Begg et al.,2011;598) remains unchanged. State F has a higher output and productivity than state E, which is the effect of a higher saving rate. "It affects levels, not growth rates" (Begg et al.,2011;598). During the transition from state E to F, there is a time when capital grows faster than labour. This produces unemployment. If the economy manages to translate to stage F, higher savings cause higher investment and production until capital per worker rises and the process repeats.

However, if the rate of saving is planned too high, it might not accomplish full employment due to it exceeding investment. This relates to the paradox of thrift as the high saving will cause a decrease in output and lower demand for final goods (Aronoff, 2016). This is part of under-consumption, the low consumer demand relative to the supply produced. Malthus emphasises the value of a varied, international market where customers can be satisfied with goods and services, leading them to consume instead of save. He also believes that full employment can be pressured in even if saving rates are capital levels.

Investment per person and output per person effect employment heavily. Supply and demand are also very important. Companies need to find the needs of consumers and satisfy them with appropriate goods and services. The Malthusian theory suggests that the government should intervene with job creation and maintain order. Although it is an old theory perhaps rejected by many, it is still relevant in it's ideas. Currently in the UK the Bank of England seems to be under control, but for example two years ago it "admitted it had no ability to control the money supply" (Pilkington, 2016). It could only set the interest rate and practically hope for the best. After all, it is the people who make economy roll.

On the other hand, the Malthusian theory has had it's share of criticism (Hoffmans, 2011). Malthus' predictions on population growth were not accurate, and he did not anticipate the technological advances in agriculture either (Seth, 2014). He was adamant on the limit of population the earth can hold, although we might never know what that limit truly is.

In conclusion, I believe that the question of whether savings increase investment expenditure does not have an absolutely decisive answer. With the Keynesian view, increase in savings makes a decline in consumption. This in turn raises the level of investment to the level of saving through inventory stocking. However, the inventories will probably be liquidated to make cash flow for new goods and services. Still, savings and investment tend to equalize over time but at any given moment they can differ unless income is at equilibrium level. With a Malthusian point of view, the effect of saving on investment is a similar one. In between states planned saving and investment expenditure (or vice versa) can be different, but at stages of income equilibrium they are always equal.

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