EC1506 Essay

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.

# Introduction

Get some numbers for UK economy. Show that this saving is actually happening.

-Big question: Is this good?

-What will investment expenditure do? What is it?

-What is the question, and how will I tackle it?

“Investment is expenditure on capital equipment and building by firms and expenditure on new residential houses by households. It also includes the change in firms’ stocks or inventories.” Page 463

Money spent on capital goods, or goods used in the production of capital goods or services. Investment spending may include spending in machinery, land, production inputs or infrastructure. Not to be confused with investment, which refers to the purchase of financial instruments such as stocks, bonds etc.

The jist of it:

Y= total expenditure = total income = total output -- In a closed economy.

Income(y) = consumption + saving

AND

Expenditure(y) = consumption + investment.

Therefore:

Saving = investment.

HOWEVER:

This does not take into account stock building (inventory accumulation), which counts towards investment.

Therefore, if consumption falls but investment in new capital stays the same, measured investment rises because firms accumulate inventories of the goods that consumers did not buy.

Basically companies make more stuff than what is bought, and that is counted towards investment. However, a lot of companies use Just in time methods, so they don’t stockpile.

This means that if stockpiling happens, depending on the good, it is bad because the goods will go bad. Companies should look out for drops in consumption as stockpiling is often inefficient.

However, if firms lower demand, incomes and savings fall. Eventually the initial rise in savings is reversed because overall income has fallen.

However, textbooks focus on aggregate savings = investment. They mean that eventually S = Buying new goods (not stockpiling). This is called the paradox of thrift. A desire by consumers to increase savings ends up just reducing output and savings do not increase at all. So basically the ratio of income to savings increases, but since income decreases due to reduced output, savings do not actually increase.

Increased savings makes it cheaper to borrow (lower interest rates) to encourage investment right?

Maybe, maybe not. However, if output is falling, firms may be reluctant to add to their capital stock.

# Body

Find a relevant economic theory.

Keynesian model?

Go through it. Discuss relevant points.

# Conclusion

Concluding paragraph, make your final point. Think about your perspective and it’s limitations.

# Essay feedback:

Focus on topic (question answered, focus on topic)

Reading and understanding. Breadth and depth of study

Analysis- critical reflection. Depth of analysis

Structure- ordering of ideas

Use of evidence

Style and presentation

# Bibliography

Research with Parkin’s book

-find economic theory to use

-information on saving vs. investment

Parkin. Eight edition.2012.

Stimulate saving

“Saving finances investment, so stimulating saving increases economic growth. The East Asian economies have highest growth rates and the highest saving rates. Some African economies have the lowest growth rates and lowest saving rates.” Page 524

“Economists claim that a tax on consumption rather than income provides the best saving incentive”. Page 525

“Investment increases the quantity of capital”.

“Saving is the amount of income that is not paid in taxes or spent on consumption goods and services. Saving increases wealth.” Page 534

“Saving is the source of funds that are used to finance investments, and these funds are supplied and demanded in three types of financial markets:”

Loan markets, Bond markets, stock markets.” Page 535.

Loanable funds market.

Funds that finance investment.

* Household saving
* Government budget surplus
* Borrowing from the rest of the world

Y ( Household’s income) = C + S + T (Page 538)

Y = sum of aggregate expenditure = C + I + G + X – M (page 462)

Subtract: I = S + (T-G) + (M-X)

Investment is financed by household savings, the government budget surplus and borrowing from the rest of the world.

The sum of private and government saving is called national saving.

Page 521

Growth theories answer the questions of: How, cause and effect of:

The growth of physical capital and human capital and technological advances make labour productivity grow.

Alternative theories of economic growth provide insights into the process of economic growth, but none provide a complete and definite answer to the basic questions: What causes economic growth and why do growth rates vary?

Three main theories for economic growth:

## Classical Growth theory:

Growth of real GDP per person is temporary and when it rises above the subsistence level, a population explosion eventually brings it back to the subsistence level.

Closely associated with: Malthusian theory

If global population explodes to e.g. 11 billion by 2050 and e.g. 35 billion by 2300, we will run out of resources, real GDP per person will decline and we will return to a primitive standard of living. We must contain population growth. Moaadern day Malthusians point to global warming and climate change that real GDP per person will decrease.

## Neoclassical growth theory:

Proposition that real GDP per person grows because technological change induces saving and investment that make physical capital grow. Diminishing returns end growth if technological change stops.

Theory on population growth:

Faced with higher opportunity costs when women get higher salaries (you cant work when u get kids), families choose to have fewer kids and birth-rate falls. Technological advances that bring higher incomes also bring advances in healthcare that extends lives. As incomes increase, both birth and death rates increase.

The planet will be swamped with more people than it can support.

Diminishing returns:

Look at growth theories supported by empirical evidence tells us that to achieve faster economic growth, we must increase the growth rate of physical capital, the pace of technological advance, or the growth rate of human capital and openness to international trade. Growth basically is

D. Begg. Economics chapter 26.4 Page 598

Explore the links between output growth, factor accumulation and technical progress.

Y = A x f(K,L)

K and L, capital and labour, combine to produce a given output of f(K,L). The function tells us how much we get out of particular amounts of K and L. f never changes.

Malthesian look:

With a fixed supply of land, population will grow faster than land. Per capita food supply would fall until starvation reduced population so that the level could be fed from land.

Starving people consume all their income. Without savings, society cannot invest in capital, so K is zero. Then the production function has diminishing returns to labour. Adding more workers drives down productivity.

Page 599:

Malthusian trap: Agricultural productivity is so low that everyone must work the land to produce food. Famine sets and people die. If better fertilizers and irrigation improve agricultural output, population expands as nutrition improves, and people are driven back to starvation levels again.

Rich countries got rid of the trap by improving agriculture without an immediate population increase, so some workers could be switched to industrial production.

In the long run, the only question of interest is what is happening to potential output itself. Neoclassical growth theory simply assumes that actual and potential output are equal.

In this long run, labour and capital grow. The steady state is the long-run equilibrium in growth theory,

Assume that labour grows at a constant rate n. Investment first widens and then deepens capital.

Labour force grows with population, but there are diminishing returns to output. When diminishing returns get to the point of output perhead to starvation levels, growth cannot continue.

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Figure 26.1

Since a constant amount of output is saved,sy shows the saving pr person. Since saving and investment are equal, it also shows investment per person.

There is no change in the production function relating output to inputs.