

Economics of Saving



November 2009

tutor2u 

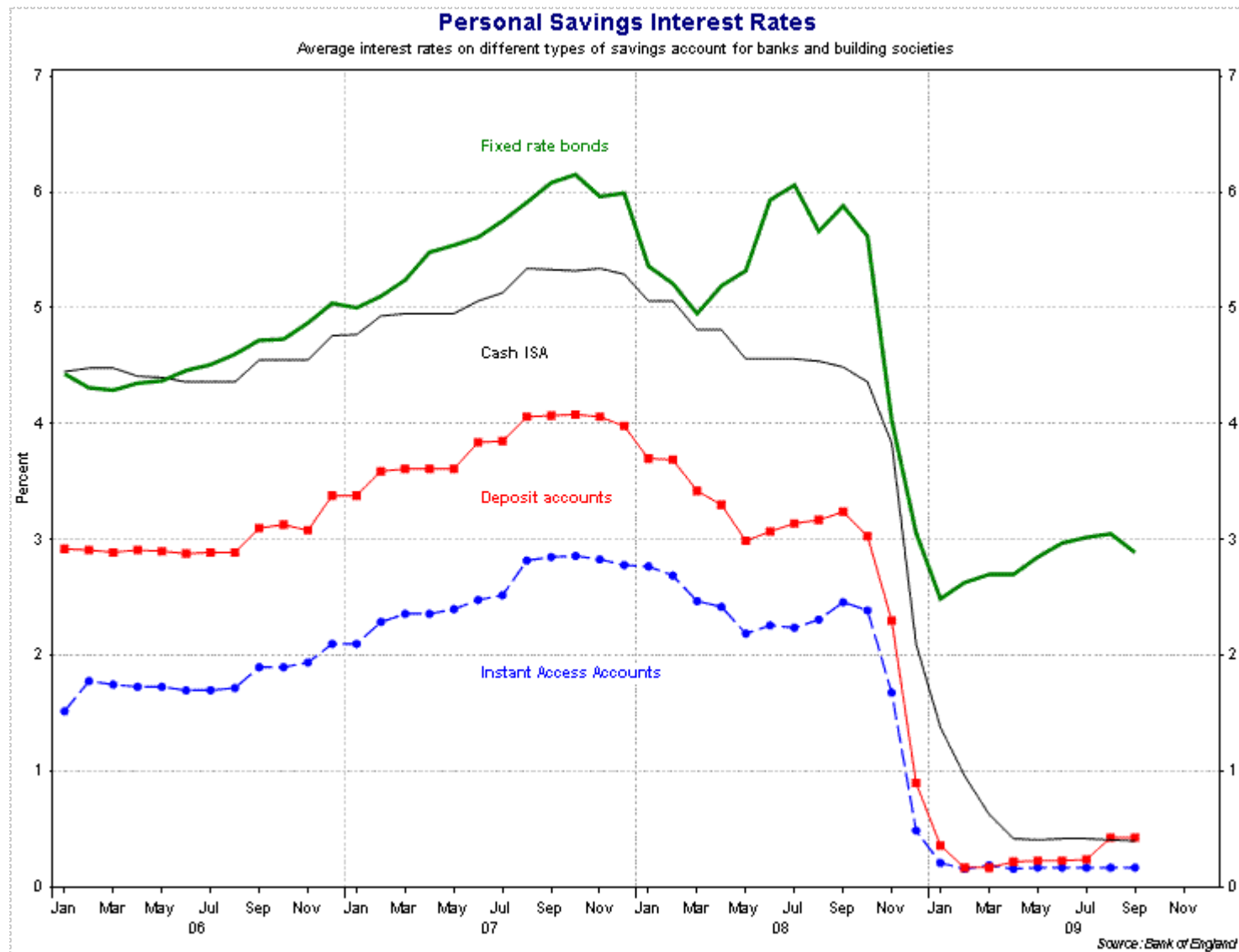
Defining and measuring saving

- Saving is deferred consumption
- It is a decision to substitute future for current consumption
- Disposable income (Y_d) can be spent or saved
- $Y_d = C + S$
- $S = Y_d - C$
- Savings ratio – savings as a % of disposable income
- Changes in savings behaviour have big effects on AD

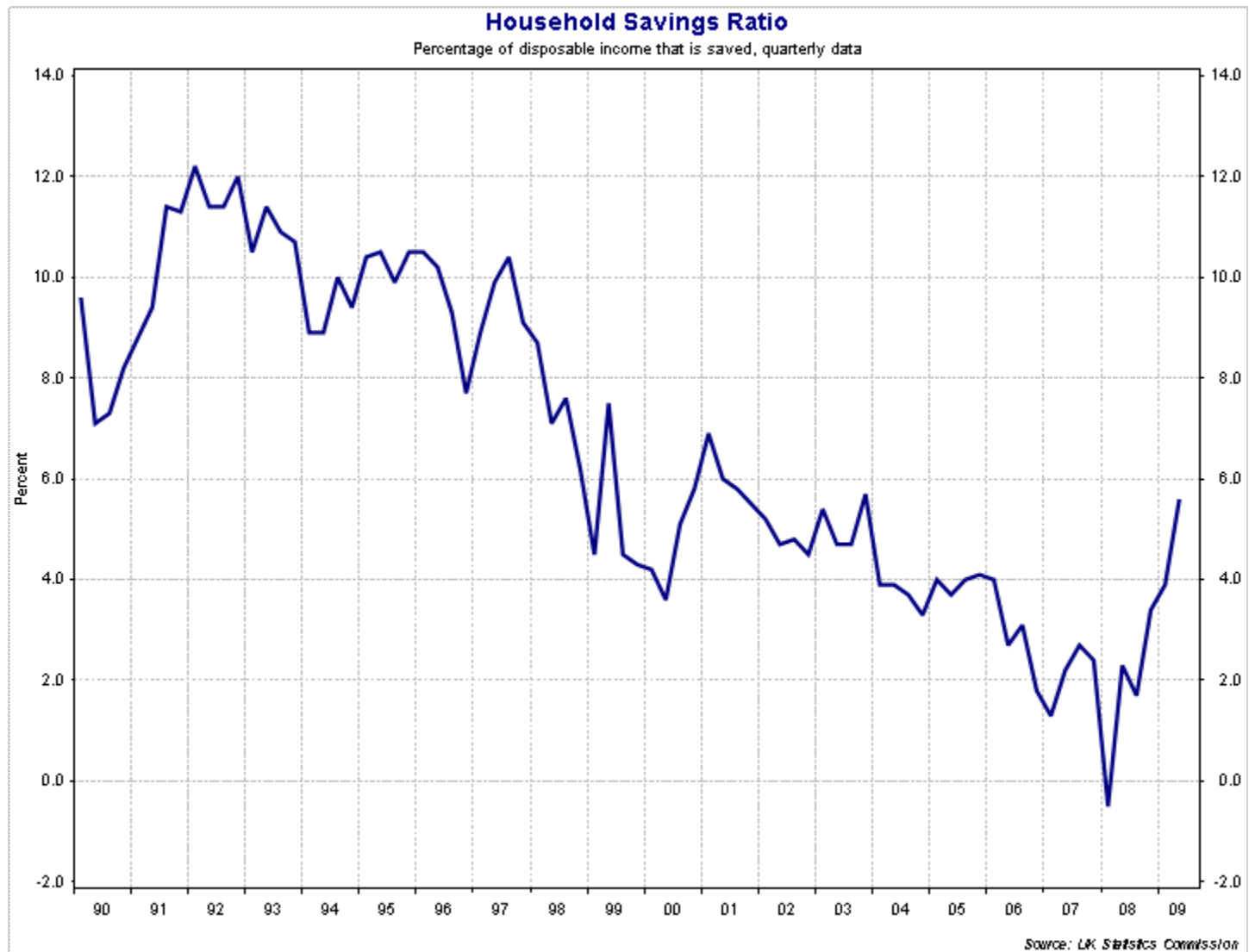
Motivations for saving

- Incentives (e.g. If real interest rate is positive)
- Providing for retirement
- Economic uncertainty
- Saving for major purchases of durables
- Saving for a mortgage deposit
- Saving to repay existing debts
- Desire to give bequests
- Expectations of future falls in the price level

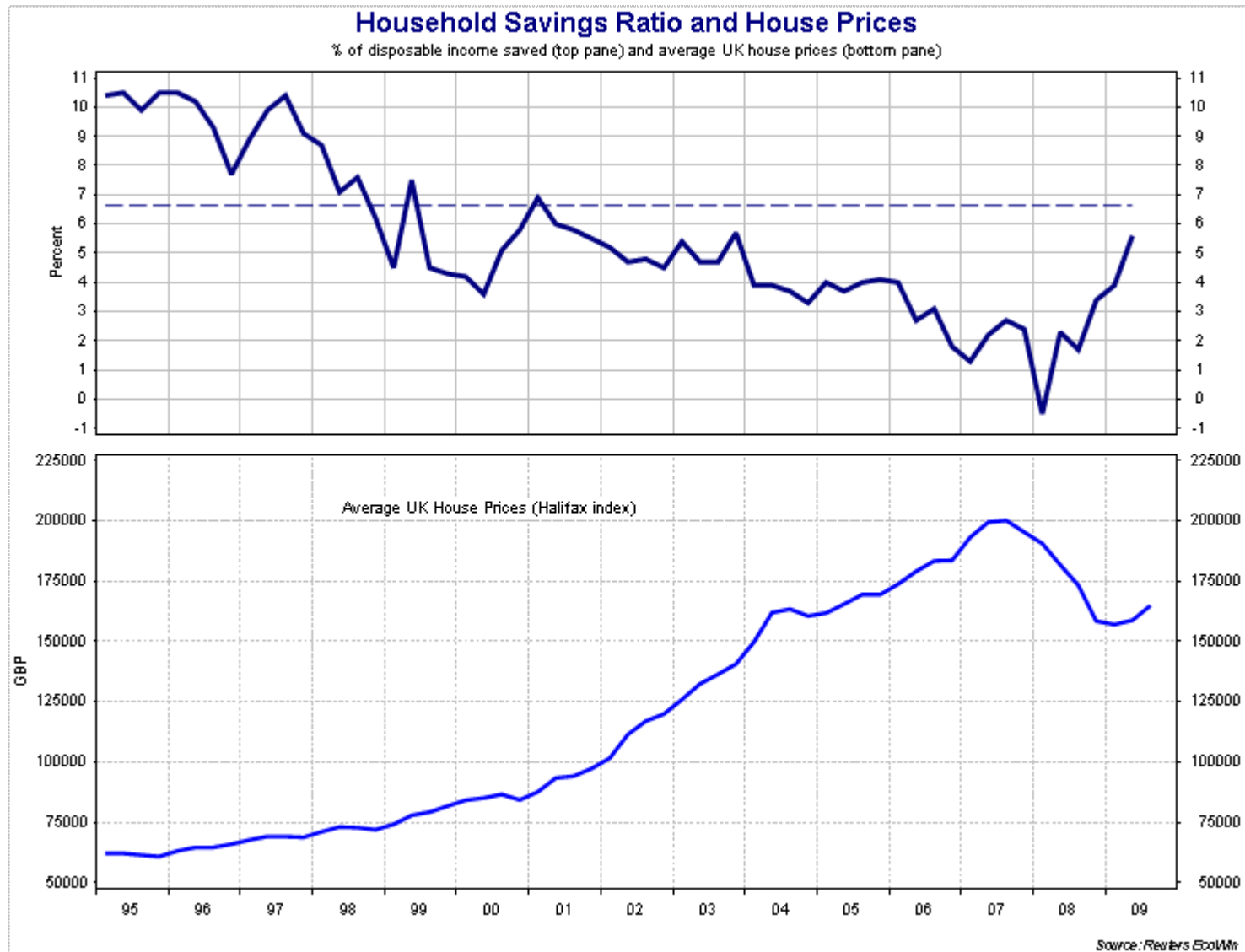
Rates of Return on Savings Have Collapsed



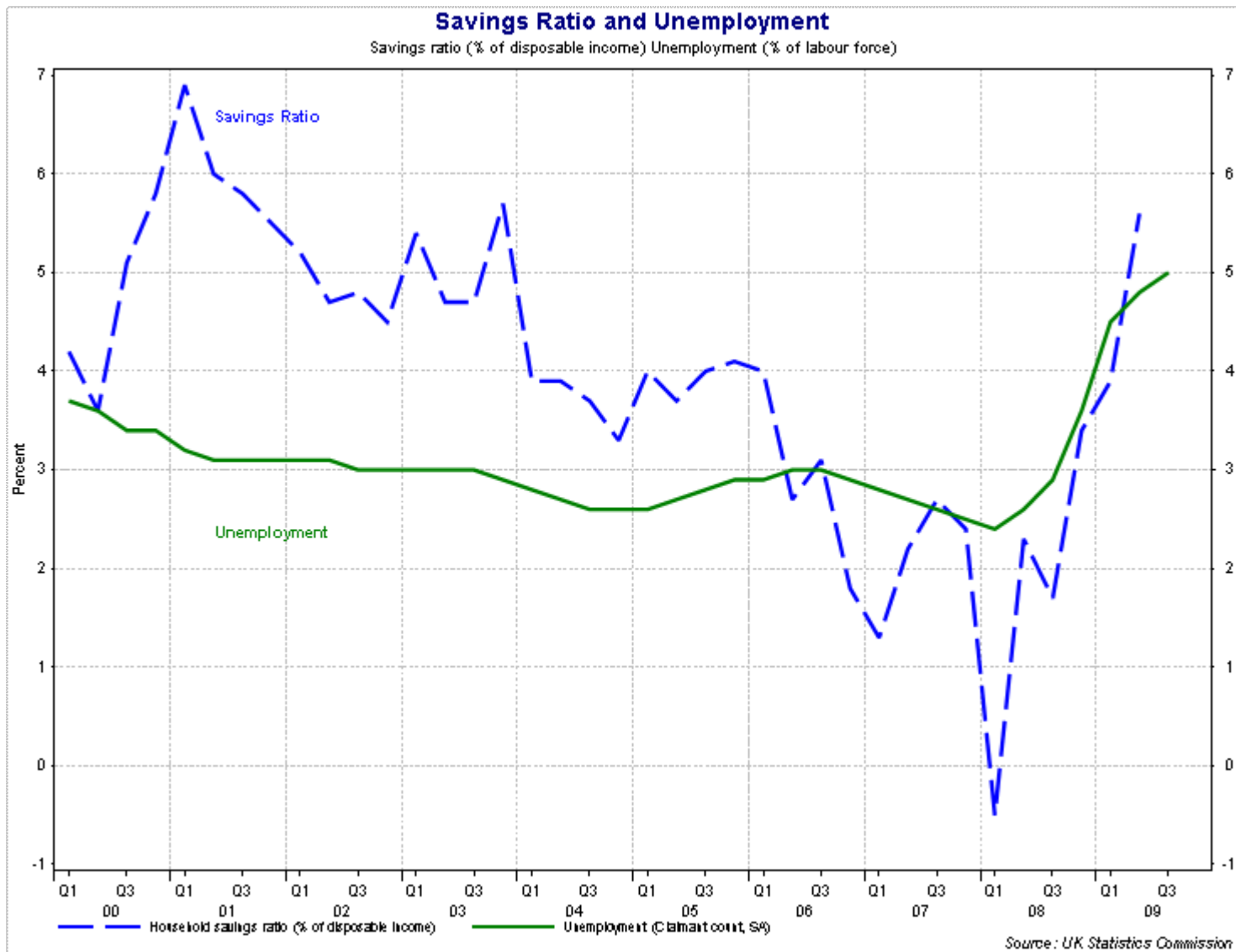
But there has a been a sharp rise in the savings ratio



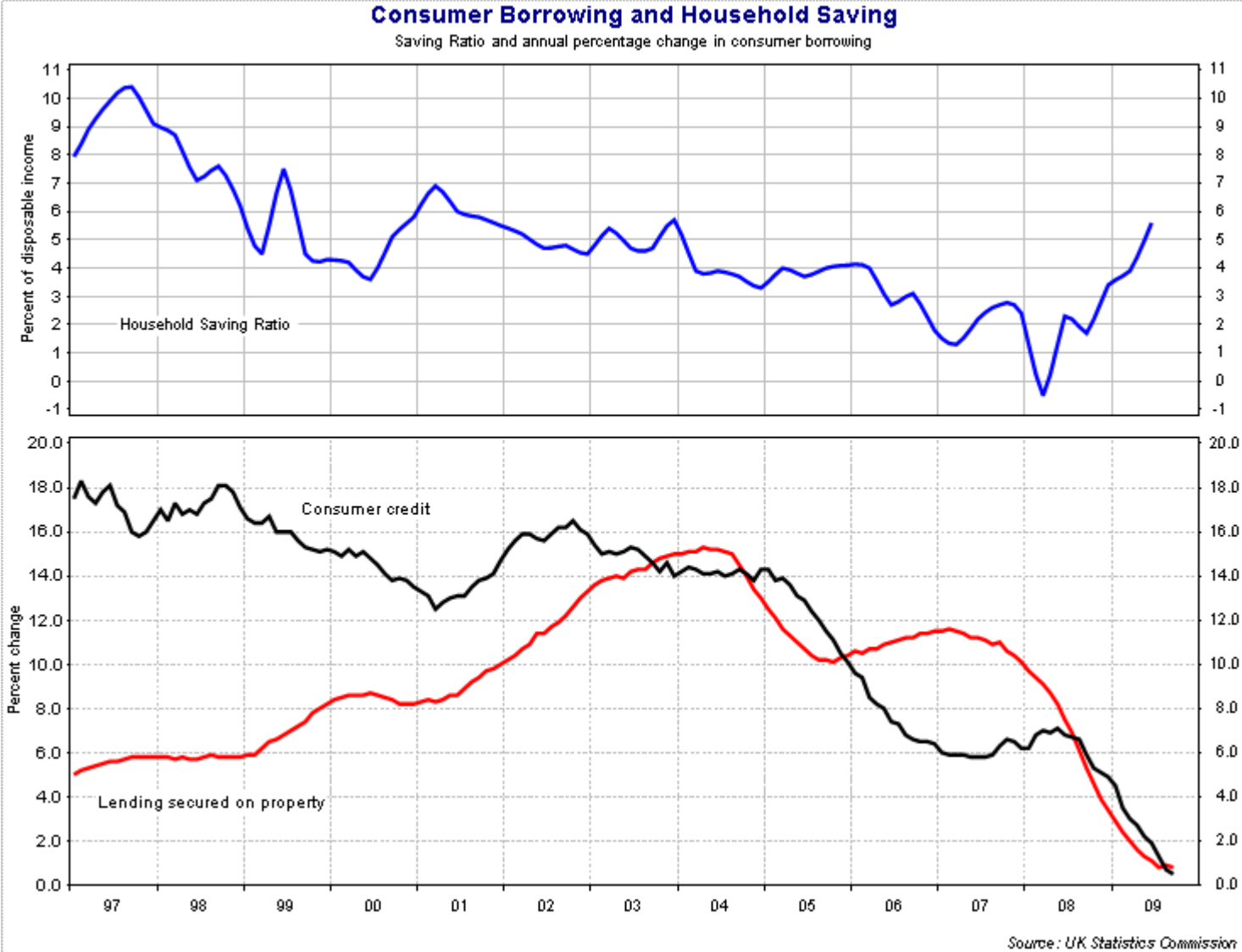
Falling property prices will have hit confidence



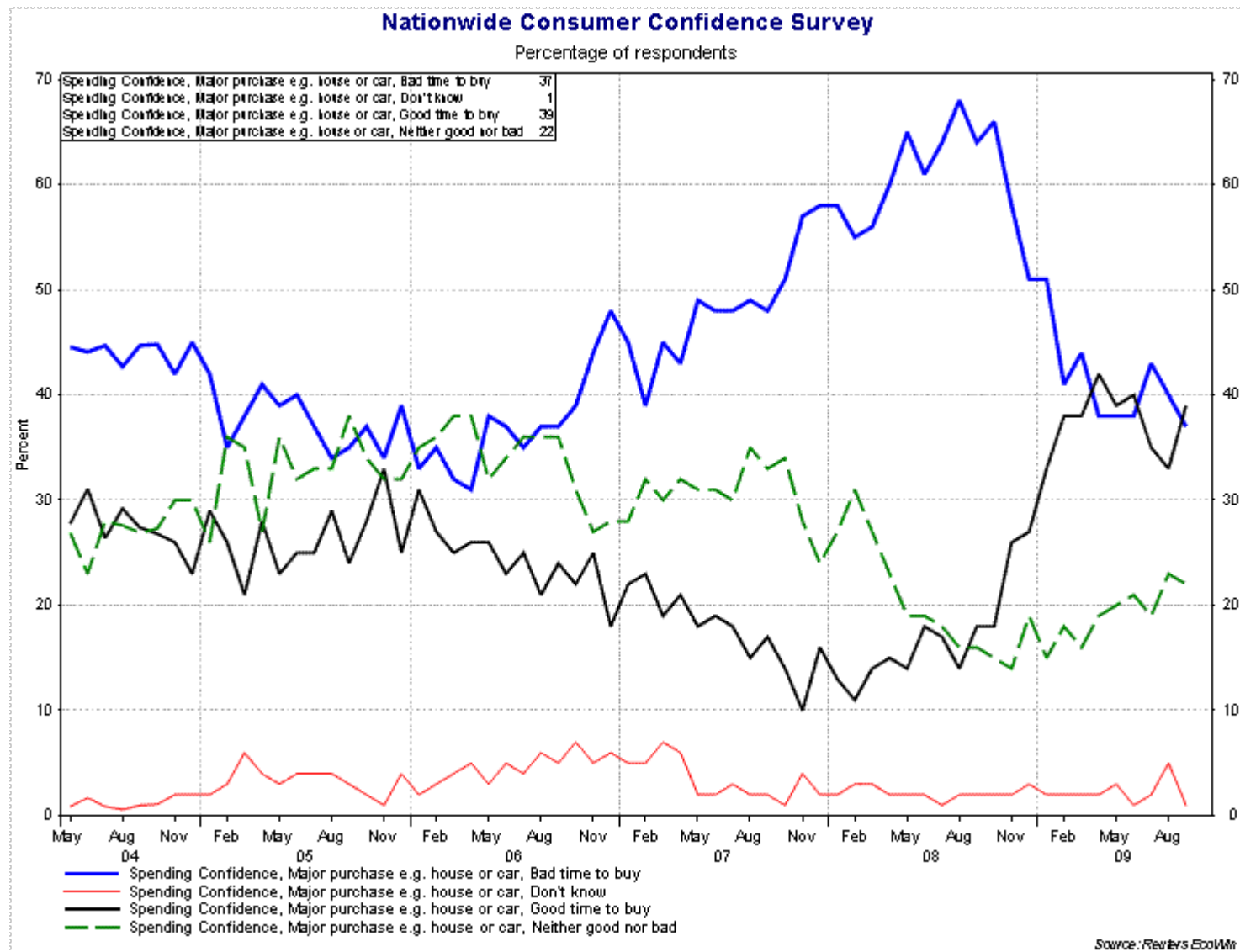
And rising unemployment prompts spending cuts



The borrowing boom represented 'dis-saving'



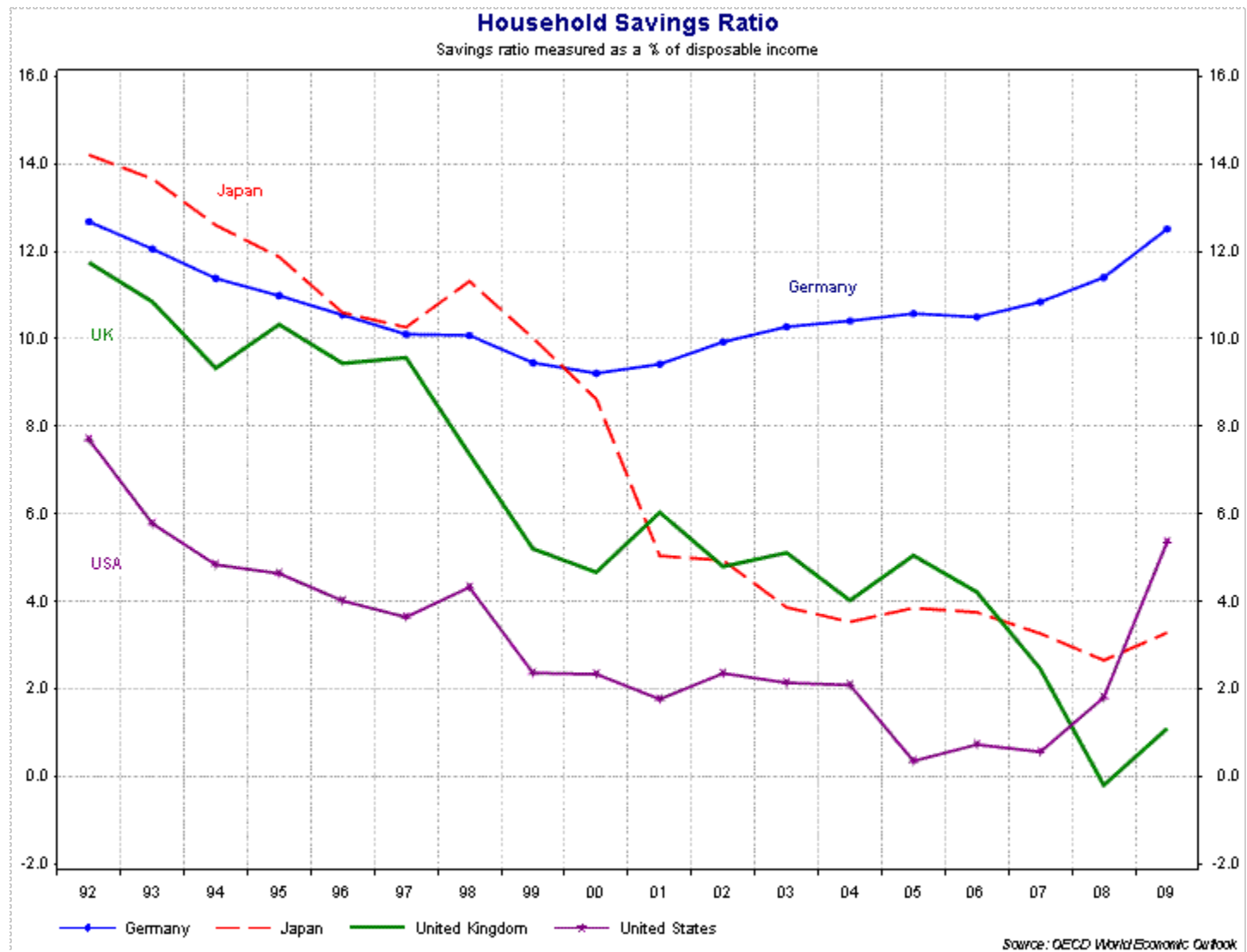
Many households now cutting back



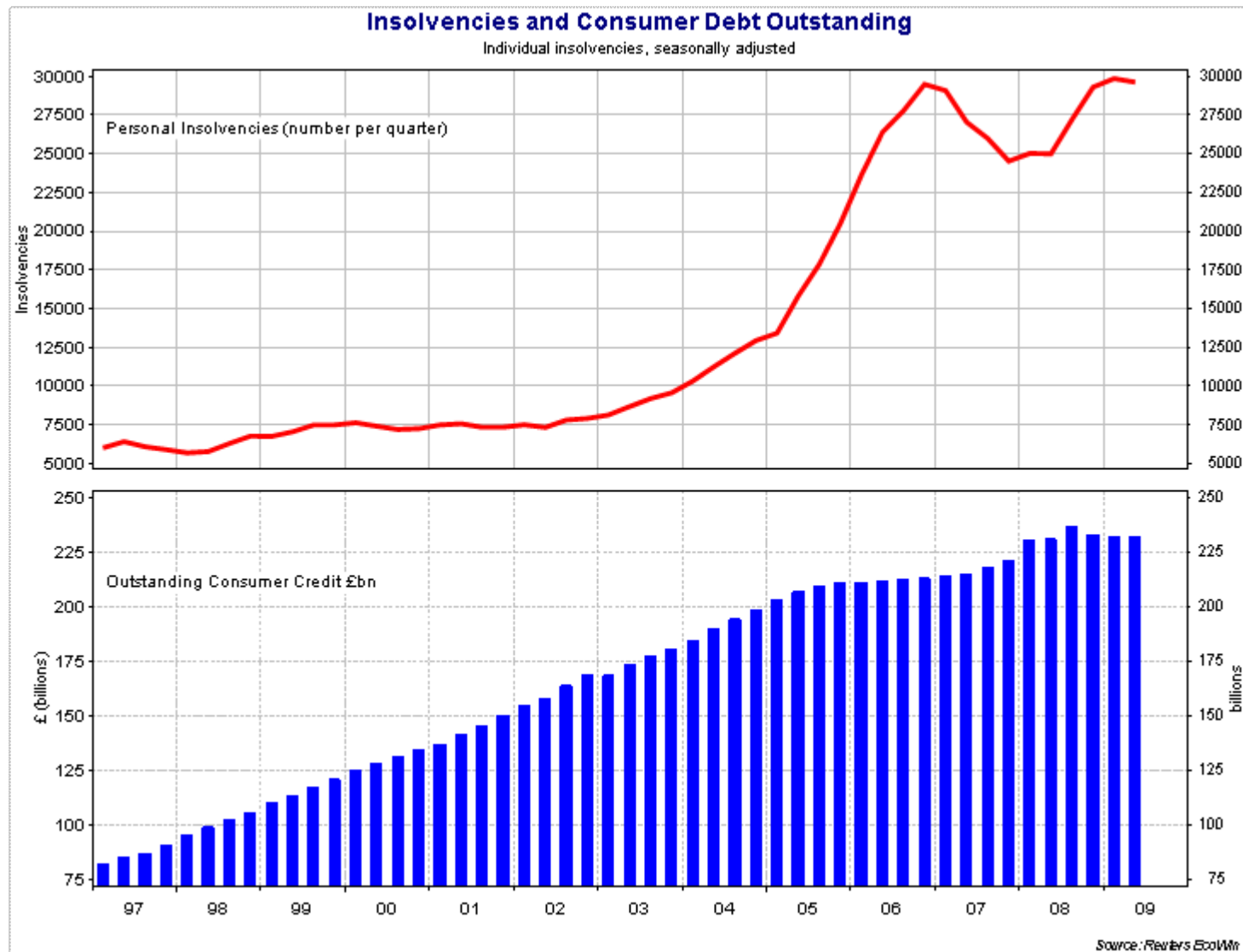
Importance of saving for the economy

- Household savings flow into financial markets
- Businesses obtain their funds from these markets
e.g. Borrowing, issuing stocks & bonds
- This investment flows back into circular flow
- Thus higher savings provide basis for funding investment – important for long term growth
- Savings provide
 - A cushion of financial stability for households
 - Funds for government when it needs to borrow

Savings rates vary across countries



Consumer debt and personal insolvencies



Dangers of a low savings ratio

- Mainly the result of high consumer borrowing
 - Rising demand for imports (growing trade deficit)
 - Built on expectations of rising property prices
- Created an unbalanced economy (over-consumption and under-investment)
- By 2008 the household savings ratio had fallen close to zero – this was completely unsustainable
- A similar situation has existed in the United States
- This eventually prompted steep increase in savings which itself can make the recession worse
- This is known as the ‘paradox of thrift’

The Paradox of Thrift

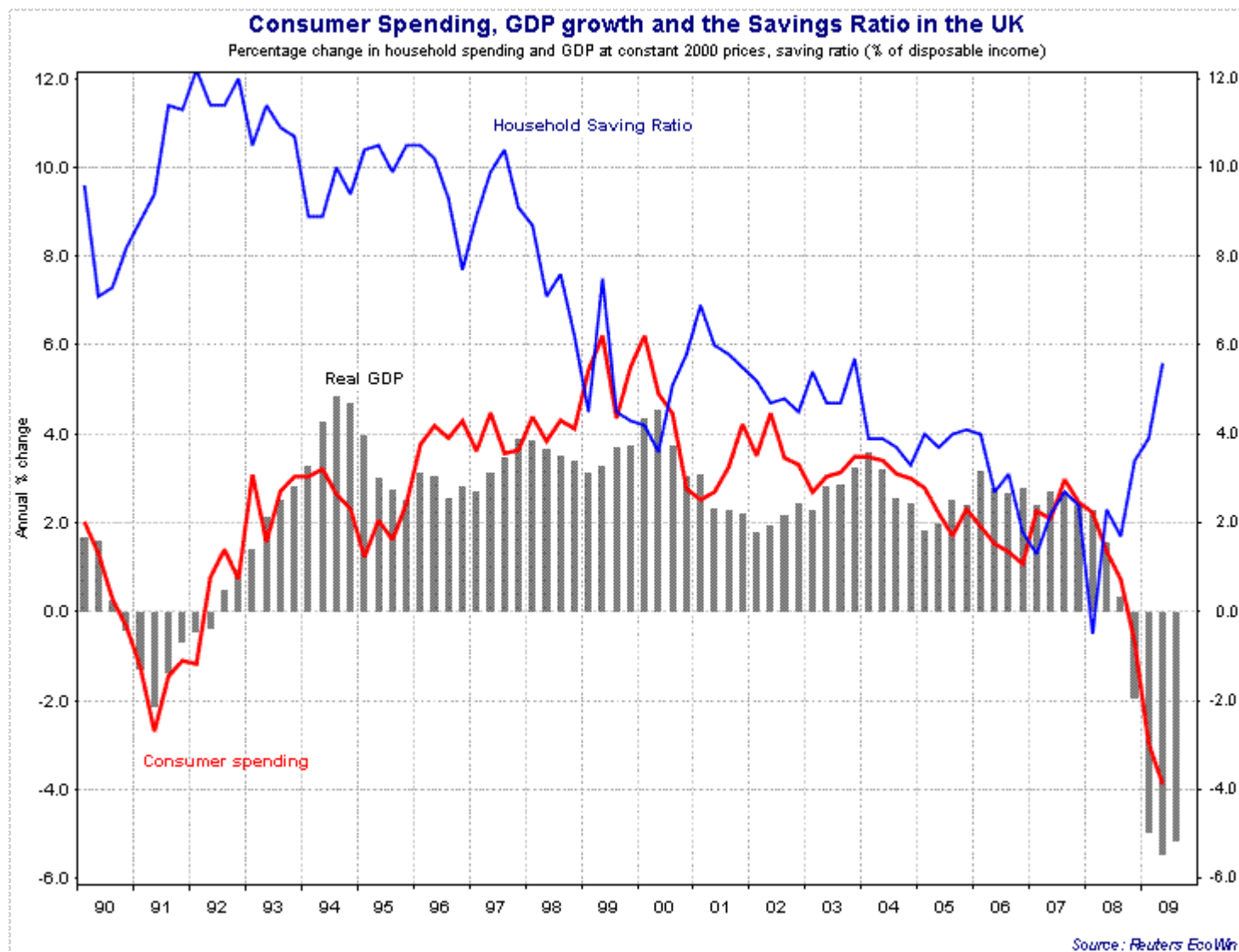
- If people save more in a recession, it will reduce consumption and thus AD will fall, impeding economic growth and lowering the general level of savings.
- Fall in demand risks causing higher unemployment and increases the danger of a deflationary depression
- [Keynes](#) first fully explained the idea in The General Theory of Employment, Interest and Money in 1936
- What is rational and virtuous for an individual might be damaging for the economy as a whole
- This is what is known as the [paradox of thrift](#)



Paul Krugman on Thrift and Fiscal Deficits

- “When the global desire to save exceeds the global willingness to invest the result is a contraction in world demand and production, a fall in incomes and employment, which eventually brings savings back into balance with investment.”
- “Business investment has fallen off a cliff because we are in a world of excess capacity. We need to find a compensating source of demand to rebalance the economy – and the solution comes from the government in the form of higher borrowing or dis-saving.”

Some evidence of a paradox of thrift effect on the UK cycle



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