MACROECONOMICS

CONSUMPTION, SAVINGS & INVESTMENT

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Consumption

- **Consumption** can be defined in different ways, but is usually best described as the final purchase of goods and services by individuals. It is also often referred to as **consumer spending**
    - Every time you purchase food at the drive-thru or pull out your debit or credit card or cash to buy something, you are adding to consumption.
    - Consumption is one of the biggest concepts in economics and is extremely important because it helps determine the growth and success of the economy.
    - Businesses can open up and offer all kinds of great products, but if we don't purchase or consume their products, they won't stay in business very long

THEORIES OF CONSUMPTION

- **Keynes** mentioned several subjective and objective factors which determine consumption of a society. However, according to Keynes, of all the factors it is the *current level of income that determines the consumption of an individual and also of society*.

  - Since Keynes lays stress on the absolute size of income as a determinant of consumption, his theory of consumption is also known as **absolute income theory**.

  - Keynes put forward a psychological law of consumption, according to which, *as income increases consumption increases but not by as much as the increase in income*. In other words, marginal propensity to consume is less than one.

S. Kuznets vision

- Contrary to Keynes's proposition that *proportion of income spent on consumption declines as income increases* (that is, average propensity to consume falls with the increase in income), Kuznets found from a statistical empirical study of consumption of the economy of the USA that *average propensity to consume had remained constant* over a long period despite the substantial increase in income.

- How the average propensity to consume has remained stable despite the substantial increase in income has been a great puzzle in consumption theory for a long time.
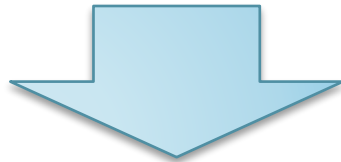
Theories of Consumption

Relative Income Theory of Consumption (J.S. Duesenberry)

- Assumptions:
  - the determinant of consumption is relative income of an individual rather than his absolute income
  - the consumption of a person does not depend on his current income but on certain previously reached income level

because his relative income has remained the same the individual will spend the same proportion of his income on consumption as he was doing before the absolute increase in his income. That is, his **average propensity to consume (APC)** will remain the same despite the increase in his absolute income.

Demonstration Effect: individuals or households try to imitate or copy the consumption levels of their neighbours or other families in a particular community. This is called demonstration effect or Duesenberry effect.

if incomes of all families increase in the same proportion, distribution of relative incomes would remain unchanged and therefore the proportion of consumption expenditure to income which depends on relative income will remain constant.

family with a given income would devote more of his income to consumption if it is living in a community in which that income is regarded as relatively low because of the working of demonstration effect.

- **Ratchet Effect** - when income of individuals or households falls, their consumption expenditure does not fall much

  - this is partly due to the demonstration effect. People do not want to show to their neighbours that they no longer afford to maintain their high standard of living.

  - partly due to the fact that they become accustomed to their previous higher level of consumption and it is quite hard and difficult to reduce their consumption expenditure when their income has fallen. They maintain their earlier consumption level by reducing their savings. Therefore, the fall in their income, as during the period of recession or depression, does not result in decrease in consumption expenditure very much as one would conclude from family budget studies.

Life Cycle Theory of Consumption (Albert Ando & Franco Modigliani)

- Idea: the consumption in any period is not the function of current income of that period but of the whole lifetime expected income

- Assumptions:
  - to plan a pattern of consumption expenditure based on expected income in their entire lifetime
  - individual maintains a more or less constant or slightly increasing level of consumption
  - his level of consumption is limited by his expectations of lifetime income

- A typical individual in this theory in his early years of life spends on consumption either by borrowing from others or spending the assets bequeathed from his parents.
- It is in his main working years of his lifetime that he consumes less than the income he earns and therefore makes net positive savings. He invests these savings in assets, that is, accumulates wealth which he consumes in the future years. In his lifetime after retirement he again dissaves, that is, consumes more than his income in these later years of his life but is able to maintain or even slightly increase his consumption in the lifetime after retirement.
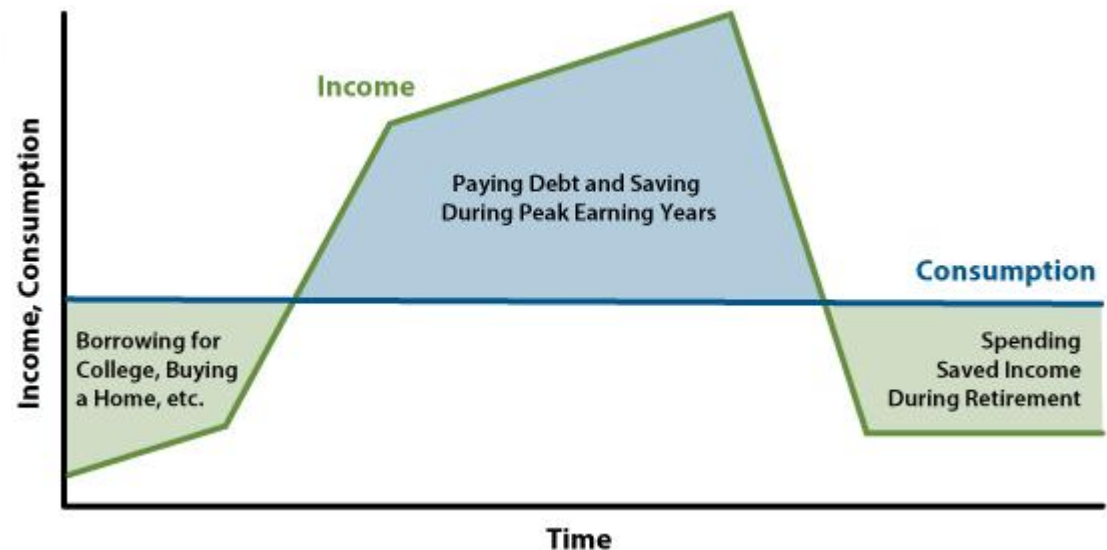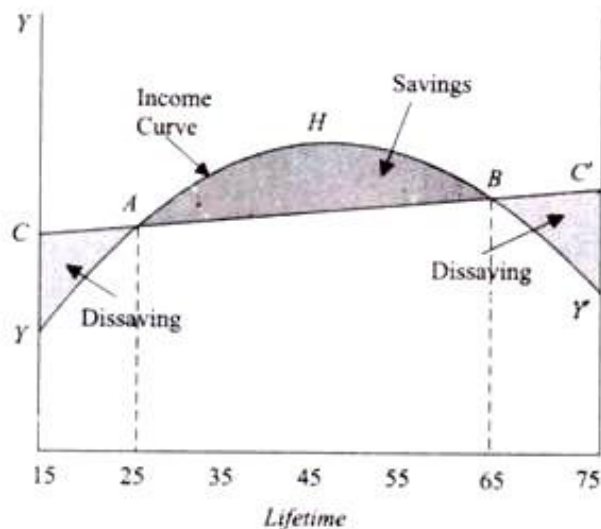
Shortcomings:

- criticized the assumption of life cycle hypothesis that in making consumption plans, households have "a definite and conscious vision."

- theory fails to recognize the importance of liquidity constraints in determining the response of consumption to income. According to critics, even if a household has a concrete vision of future income, the opportunities to borrow from the capital markets for quite a long period on the basis of expected future income are very little.

PERMANENT INCOME THEORY OF CONSUMPTION (MILTON FRIEDMAN)

⬚ Assumptions:

- consumption is determined by **long-term expected income** (permanent income) rather than current level of income *(According to Friedman, an individual who is paid or receives income only once a week, say on Friday, he would not concentrate his consumption on one day with zero consumption on all other days of the week)*

- an individual would prefer a smooth consumption flow per day rather than plenty of consumption today and little consumption tomorrow. Thus consumption in one day is not determined by income received on that particular day.

- permanent income or expected long-term average income is earned from both "human and non-human wealth"

- Relationship between Consumption and Permanent Income: $Cp = k(i,w,u) \times Yp$

Cp – permanent consumption;

Yp – permanent income

k - the proportion of permanent income that is consumed

  - **Rate of interest** (i): at a higher rate of interest the people would tend to save more and their consumption expenditure will decrease.

  - **The proportion of non-human wealth to human wealth** (w): the greater the amount of wealth or assets held by an individual, the greater would be its propensity to consume and vice-versa

  - **Desire to add to one's wealth** (u): households' preference for immediate consumption as against the desire to add to the stock of wealth or assets also determines the proportion of permanent income to be devoted to consumption

- In addition to **permanent income (Yp)**, the individual's income may contain a transitory component - **transitory income (Yt)**. A transitory income is a temporary income that is not going to persist in future periods.

When income of an individual increases in the current year as compared to the last year, the permanent income will be less than the current year's income. This is because individual is not sure whether the increase in income will persist in the future and therefore does not immediately revise his estimate of permanent income by the full amount of the increase in his income in the current year

Conclusions:

- Permanent income hypothesis is similar to life cycle hypothesis and differs only in details

- Permanent income hypothesis is also consistent with the evidence from the cross-sectional budget studies that high income families have low average propensity to consume than that of low- income families. A sample of high income families at a given time is likely to contain a relatively larger number of families who are having positive transitory increase in incomes.

- laying stress on changes in rate of interest and the wealth or assets held by the people and desire to add to one's wealth as important determinants of consumption and savings, Friedman's permanent income hypothesis has made an important contribution to the theory of consumption and saving.

REAL INCOME VS. NOMINAL INCOME

☐ The term 'real' that is used in describing income refers to how your income is affected by **inflation**, or the natural rise in prices of goods and services. So to elaborate, if your income went up 5% in a year, but the price of goods or inflation went up 5% also, your real income remained flat. You can't really buy or consume any more goods than you could before.

SAVINGS

- Savings, according to Keynesian economics, consists of the amount left over when the cost of a person's consumer expenditure is subtracted from the amount of disposable income he earns in a given period of time. For those who are financially prudent, the amount of money left over after personal expenses have been met can be positive; for those who tend to rely on credit and loans to make ends meet, there is no money left for savings.

- Saving involves income that is not consumed

- Savings can be turned into further increased income through investing in different investment vehicles.

  - Saving is often confused with investing, but they are not the same.

  - Although most people think of purchases of stocks and BONDS as investments, economists use the term "INVESTMENT" to mean additions to the real stock of capital: plants, factories, equipment, and so on

Types of Savings

Personal savings

- What people save, avoiding to consume all their income, is called "**personal savings**". These savings can remain on the bank accounts for future use or be actively invested in houses, real estate, bonds, shares and other financial instruments

National savings

- National savings = personal savings + the business savings + public savings.
- Business savings can be measured by the value of undistributed corporate <u>profits</u>. Public savings are basically <u>tax revenues</u> less <u>public expenditure</u>.

INVESTMENTS

☐ Definition: Money committed or property acquired for future income.

"INVESTMENT" to mean additions to the real stock of capital: plants, factories, equipment, and so on.

☐ *An investment is an asset or item that is purchased with the hope that it will generate income or will appreciate in the future. In an* **economic sense**, *an investment is the purchase of goods that are not consumed today but are used in the future to create wealth. In* **finance**, *an investment is a monetary asset purchased with the idea that the asset will provide income in the future or will be sold at a higher price for a profit.*

- **Leverage Firms (Companies),** are the best place to invest, because it's Earning per share is high. So, the high amount you put the more profit you gain from your share or stock.

  Always invest in that firm or thing whose rate of return or profitability in future is high

- **Fixed Investment** - is spending on new capital machinery and plant, construction, housing, vehicles, etc.

- **Working Capital** - is spending on stocks/ inventories of finished goods and raw materials. The accumulation of stocks by firms, whether voluntary or involuntary, is counted as investment

Types of Investments

Traditional investments:

- In finance, the notion of **traditional investments** refers to putting money into well-known assets (such as <u>bonds</u>, <u>cash</u>, <u>real estate</u>, and <u>shares</u>) with the expectation of <u>capital appreciation</u>, dividends, and interest earnings

FINAL CONCLUSIONS

- Consumed is what you buy or ability to pay.
- High consumption makes any product to stay long in market.
- If consumption is not high then product will failed.
- Saving is what you have after all your expenses.
- Saving is not what you invest.
- Investment is for the future profits.
- Investment made when the earning per share of the company is high.