Introduction to Economics of Development

Special Topic:

Economics of Saving

What’s Happening 02/12/08

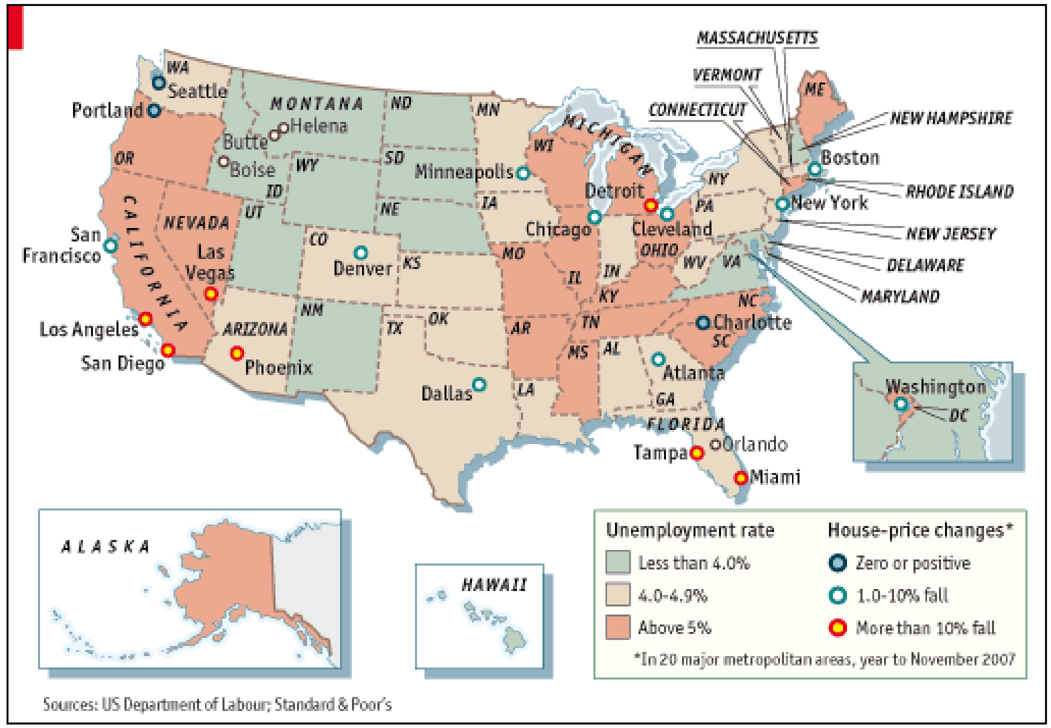
Paulson Unveils 'Lifeline' Plan

Associated Press

The Bush administration announced a new initiative put together by six of the nation's largest financial institutions, offering to "pause" the foreclosure process for seriously troubled homeowners. 12:59 p.m.

- Scrutiny Tightens for Title Insurers
- Loan Provisions Bring Losses to IndyMac
- Econ Blog: Economists Divided on Stimulus Plan's Effects

“Weakest Link” in the United *States*



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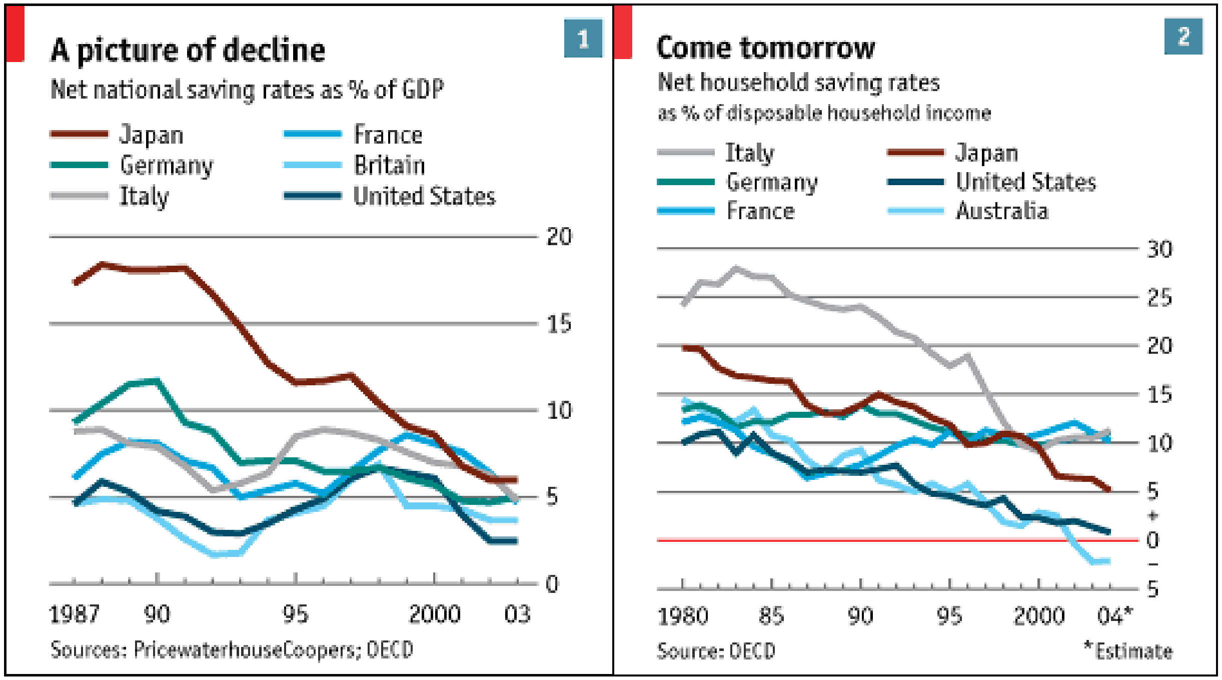
Declining Trend in savings (developed economies):



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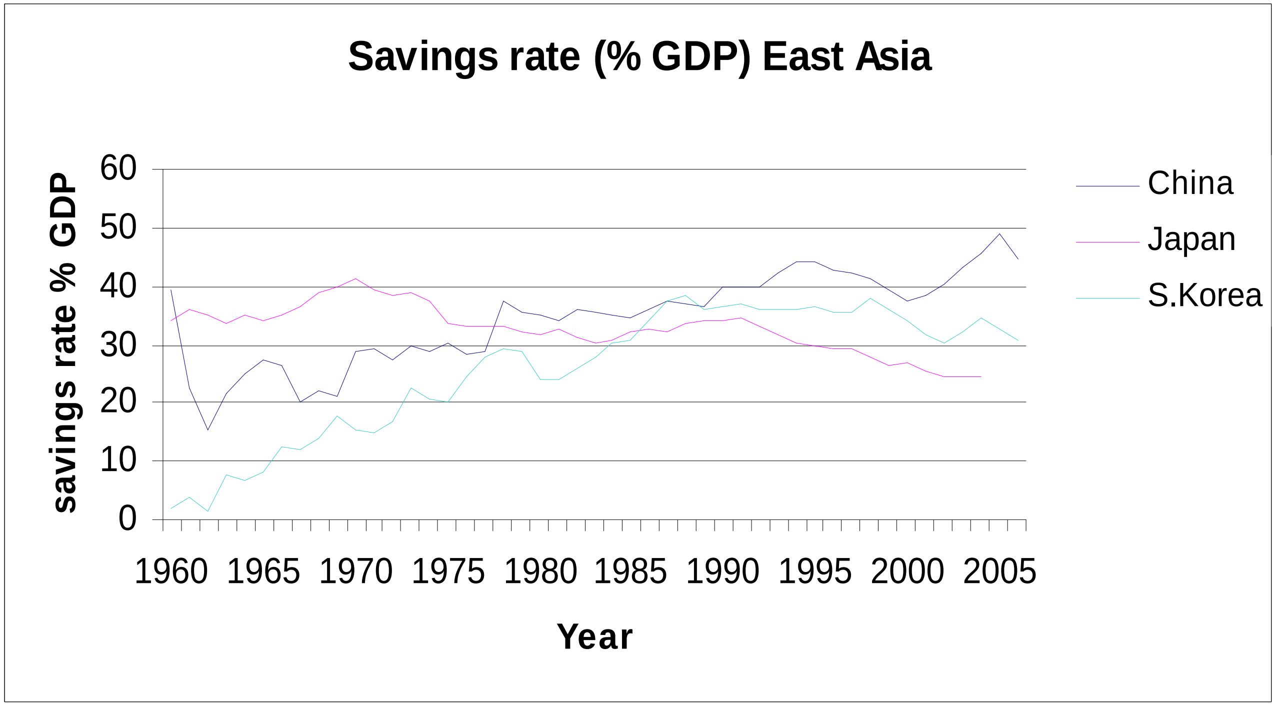
Savings in East Asian countries:



Source: WDI online

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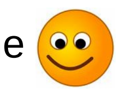
- **Why do people save?**
  - Precautionary savings
    - If one thinks future prospect will be bad or too uncertain, he tends to save more today. 
    - If one thinks he will have a bright future (in terms of higher income), he tends to save less today. 
  - Consumption smoothing across different time horizons
    - Also known as *inter-temporal consumption smoothing*
    - The effect of real interest rate
      - Case 1: High rate today, expected low rate later → save more today
      - Case 2: Low rate today, expected high rate later → save less today
    - If people are not myopic and think strategically, a sudden (one-time) increase of income, say, from tax cuts, is unlikely to induce consumers to consume more today. People might save the money if they realize,
      - the current tax cuts are funded by increased government overspending, and to keep government budget balanced in the future, government needs to raise tax.
      - anticipating future tax increase, household might save what they've got today in order to offset the negative impact of tax increase in the future.

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- **Why do people save? (continued)**
  - Consumption smoothing between generations
    - Parents save for their children. Is this simple altruism?
      - It might be. In that case, parents tend to treat the family as a whole.
      - It may be partly due to that parents expect their children to support them when they get old. This is true in many developing countries →the role of social safety net in developed countries.

  - People are more likely to save if they can't borrow
    - This often happens in developing countries, where people don't have access to credit because of backward financial system:
      - Banks or lenders can't tell whether consumers are credit worthy because consumers' credit history is unavailable.
      - No sophisticated financial products like mortgage equity loans.
      - No access to international financial markets
  - Other reasons:
    - social and cultural: saving as habit and virtue

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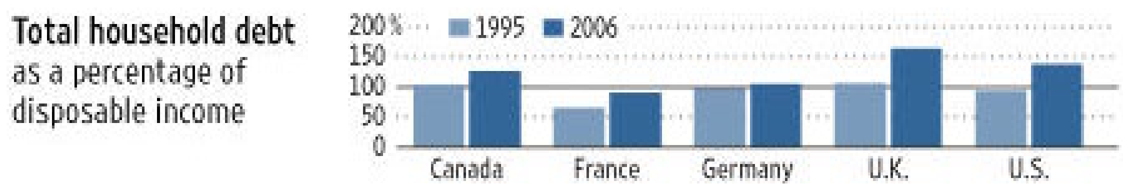
- The danger of saving “too little”
  - Insufficient capital to sustain economic growth (be reminded $Y = F(K, L)$)
  - Governments save too little (or overspending)
    - Soaring Budget deficit *may* mean higher tax in the future, bad for economic growth
    - May have “crowd-out” effect toward private investment, or just simply increase their borrowing cost.
    - If governments rely on international financial markets to borrow, more susceptible to international financial crises.



  - Individuals save too little (over-consumption)
    - Trade deficits may increase a lot and cause global imbalances
    - When economic shock or catastrophe hits, credits are often unavailable when most needed, due to tightened lending standards →credit crunch

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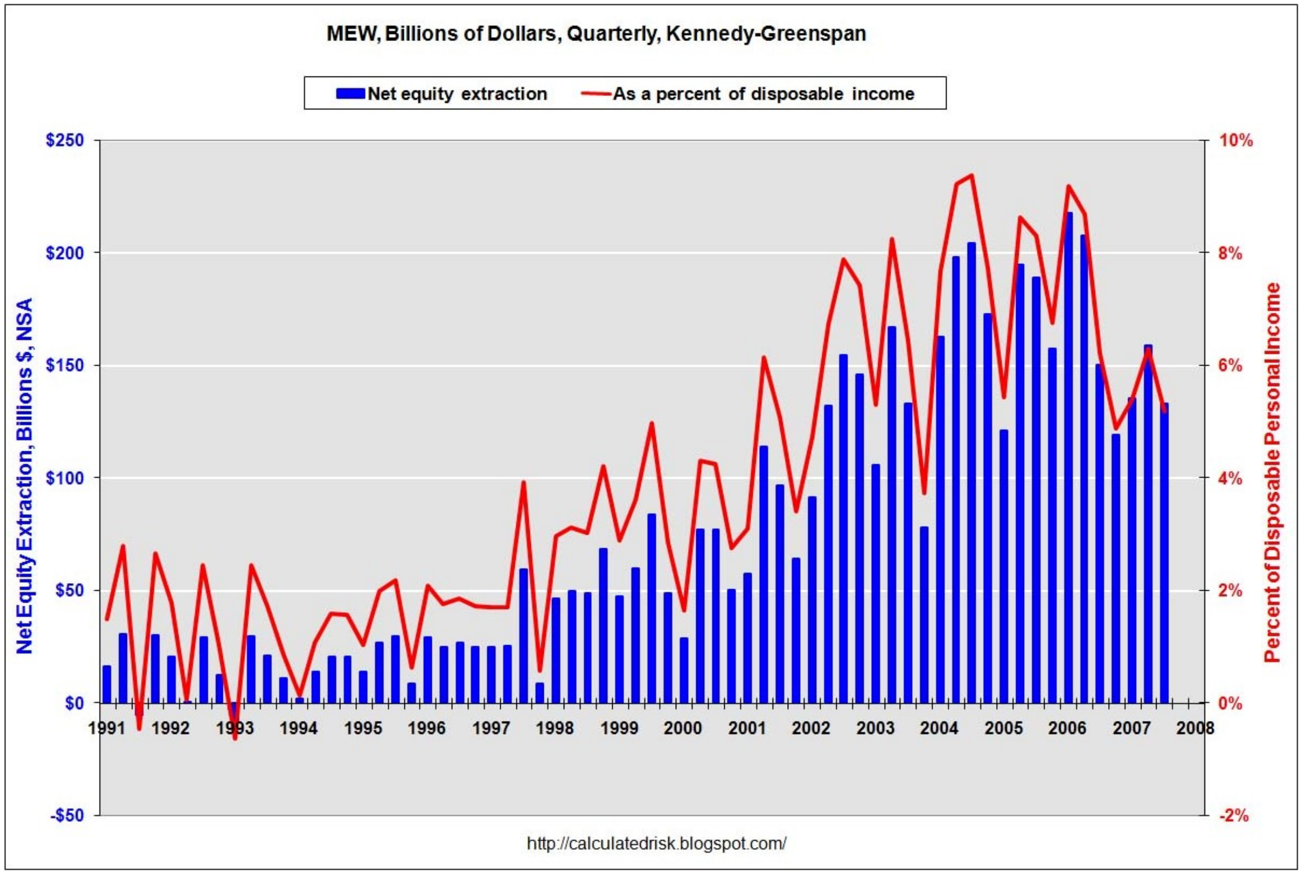
Spending on credit: mortgage equity withdrawal (MEW) in the U.S.



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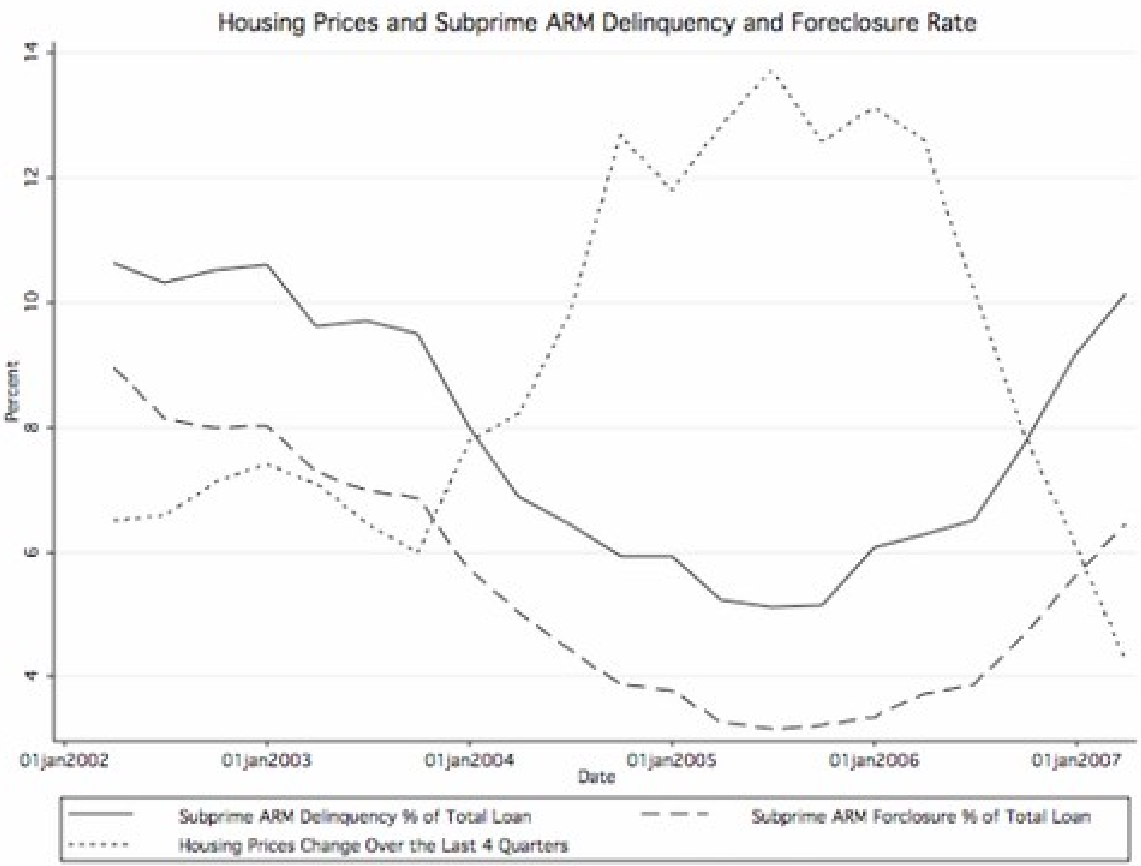
In a time of credit crunch and falling housing prices:



Source: Mortgage Bankers Association and OFHEO

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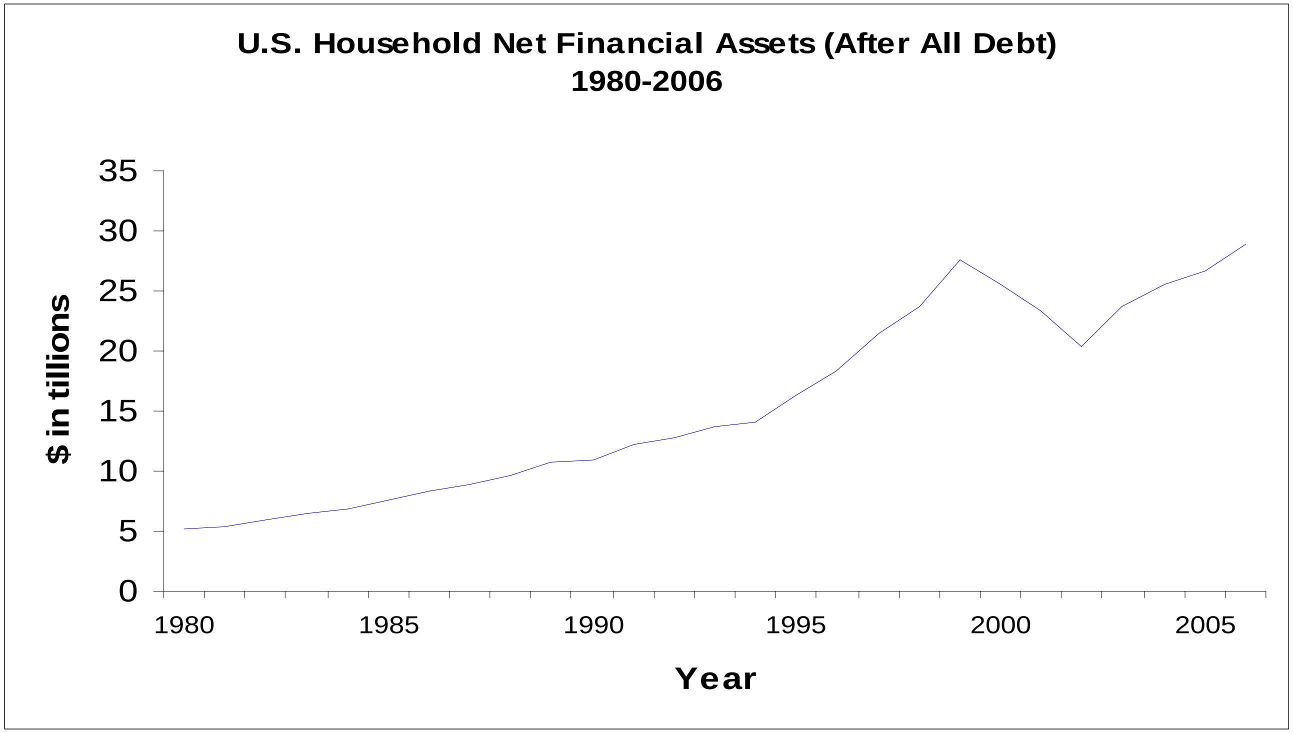
Is America Running on Empty?

First look at personal savings rate in the U.S.

Special Topic: economics of saving

Is America Running on Empty? (Alternative view)

"Absolutely not", says David Malpass, chief global economist at Bear Stearns, "The published savings rate is calculated by subtracting personal spending from a narrow definition of personal income after taxes…it excludes investments, 401k savings and other pension benefits, etc, and most important, capital gains of these financial assets."



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- The danger of saving “too much”
  - Too much capital chasing profits →drive down returns
  - Too much savings → too much money waiting to be lent out →easy bank lending standards →more bad investments →waste of capital
  - Tendency to over-invest → overheated economy → higher inflation

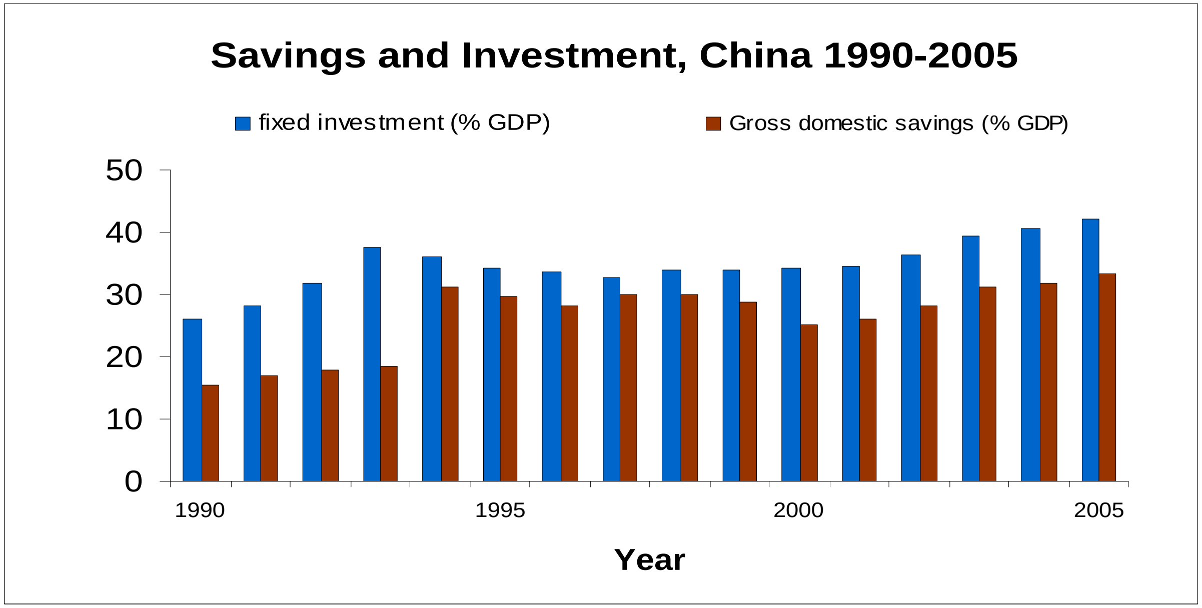

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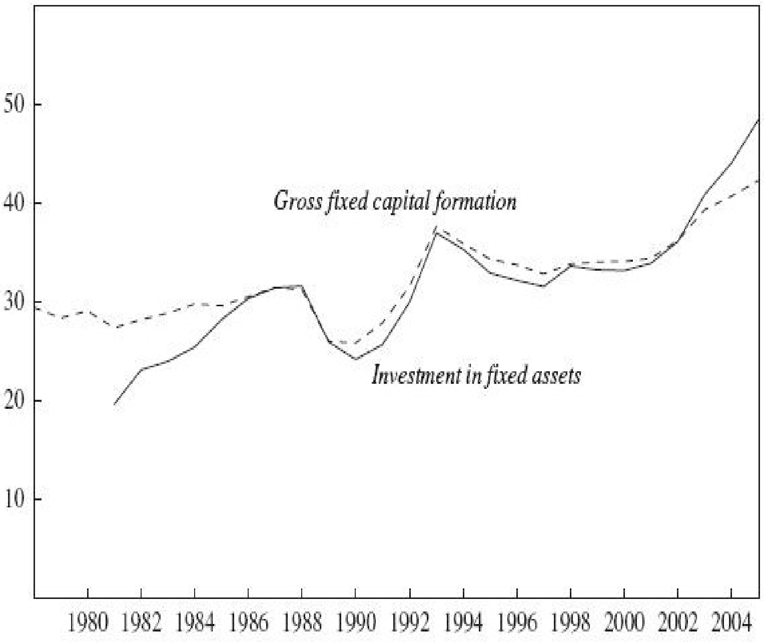
Figure 1. Investment in China, 1978–2005

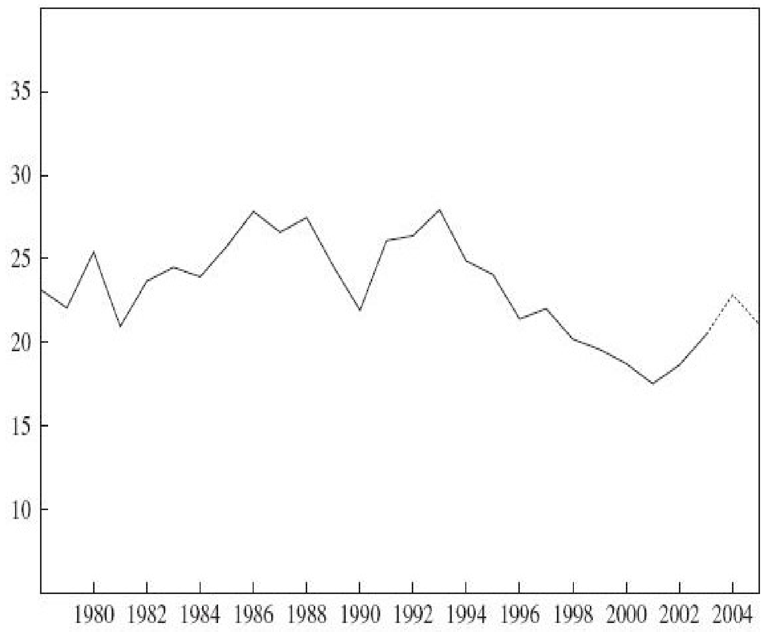
Percent of GDP



Source: NBS.

Figure 2. Base Case Estimate of Return to Capital, 1978–2005[a]

Percent a year



Sources: NBS and authors' calculations.
a. Dashed line indicates preliminary results.

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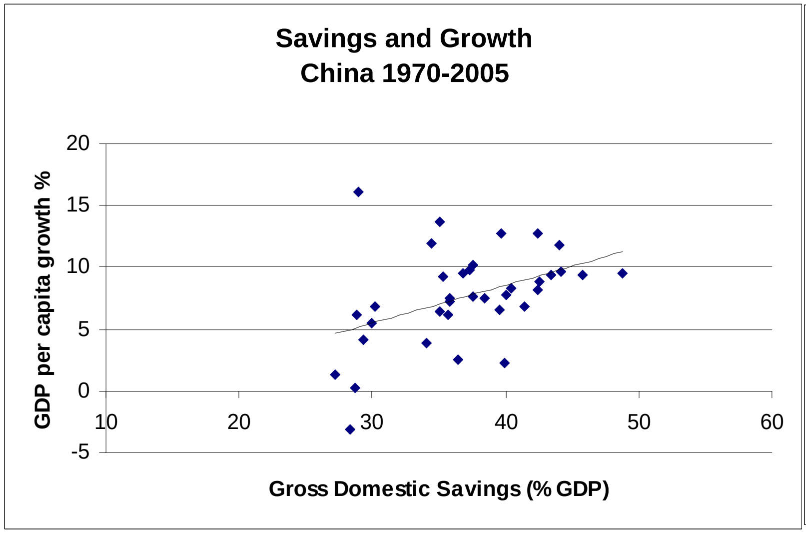
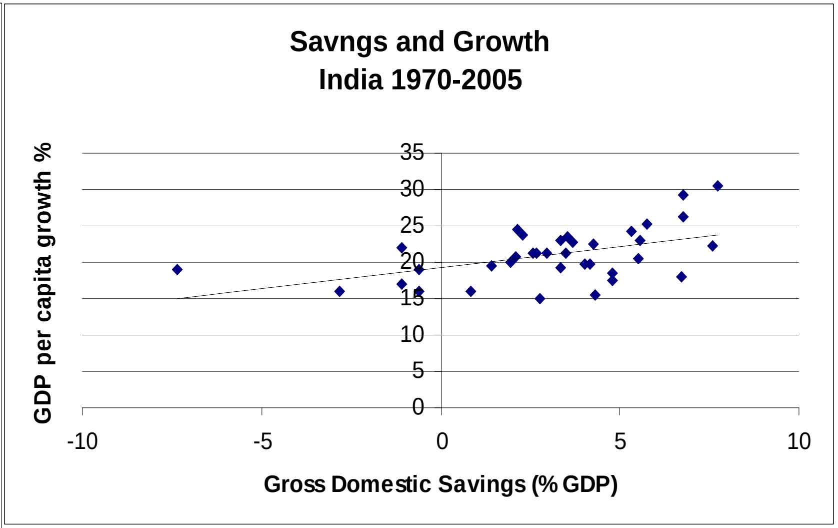
- Savings and economic growth
  - What are the empirical results?





➔ In developing countries, seems that there is a positive relationship.

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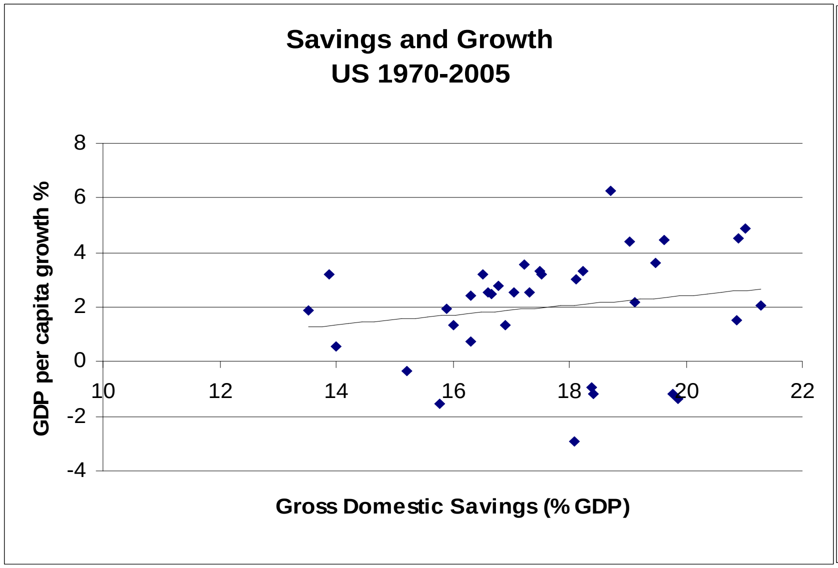

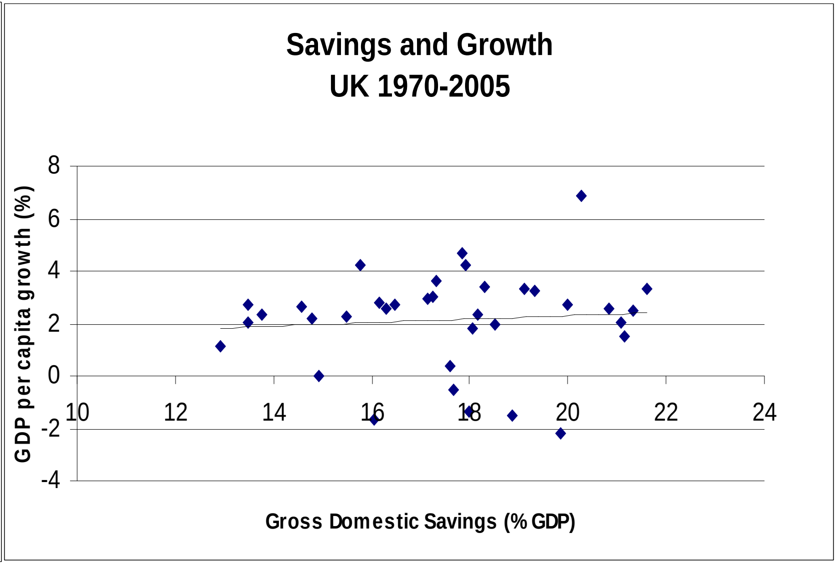

➔ In developed countries: the relationship is less clear.

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- Savings and economic growth
  - What can we learn from the theory?
    - Capital is important for growth, but it eventually suffers diminishing returns, so the first implication is that savings and capital are more important for economic growth at initial stage, but less so in very long term where economy is close to steady state. Therefore, we might find strong positive relationship between savings and growth only in developing countries.

    - Developed economies are likely to be more knowledge intensive, where economic growth is mainly driven by factors other than capital investment, such as innovation and technology. So we probably will not find a definite relationship between savings and economic growth for the developed countries.