

ECON 10003 INTRODUCTORY MACROECONOMICS

SEMESTER 1, 2013

EXAM NOTES

LECTURE 1:

LECTURE 2:

LECTURE 3:

LECTURE 4:

Note: Inflation does not reduce the real income of the economy → the real economy increases WITH inflation.

- **What are the economic costs of inflation?**

Distribution of Incomes

Some will be better off in terms of REAL income, some will be worse off. However, the economy in the aggregate does not become better or worse off.

Ability

- **What are other likely consequences of inflation?**
- **What is deflation and why is it seen to be a problem?**

LECTURE 5:

- **Relationship between saving and wealth**

Savings- portion of income not devoted to satisfying current needs) (FLOW)

Wealth- the value of the STOCK of assets accumulated from savings.

IE: the money you save goes somewhere... it doesn't just sit there... you may use that money to purchase assets, so assets are still part of WEALTH.

→ Financial assets- money, shares, interest bearing shares...

→ Physical assets- property, gold, diamonds and consumer durables

Net worth- difference between the assets and liabilities

WEALTH IS THE VALUE OF THE STOCK OF ASSETS ACCUMULATED FROM SAVING, A FLOW
VARIBABLE

As income rises, savings rise, and wealth can rise too

Note: flow variables are measured with respect to time. (\$20/month)

Savings are not the only way Wealth increases. Capital Gains and Capital losses also change wealth by changing the VALUE of EXISTING ASSETS.

Capital gains → increases in the value of existing assets.

Capital losses → decreases in the value of existing assets.

$$\text{CHANGE IN WEALTH} = \text{saving} + \text{capital gains} - \text{capital losses}$$

WHY DO PEOPLE SAVE?

Life cycle saving

Saving for long-term objectives. EG: retirement, university, purchase of a home.

People undergo life cycle saving to achieve their optimum wealth-income ratio at some point in their life cycle.

- If wealth decreases (ie: due to capital gains or losses), people may try and compensate the decrease in wealth by increasing savings, to achieve the wealth-income ratio they want again.

NOTE: this type of saving just relates to any type of long term goal. People often have an optimum wealth-income ratio when they're saving for the long term.

Bequest saving

Saving for leaving an inheritance. EG: giving a good start to your children

Precautionary saving

Saving for a rainy day. EG: when there is a decrease in confidence, people save more. It is a way of guarding against an unexpected increase in expenditure.

Although these are reasons why people save, how much people save also depends on interest rates... the higher the **real IR**, the more willing to save.

Why is the **real IR** the thing which changes saving patterns? Unless people are subject to the "money illusion", logically, you look at the **real income** to see if you're better off.

- **Distinction between nominal and real rate of interest**

In saving, you give up consumption pleasures. The reward for waiting? EARNING INTEREST

It is the real interest rate that will determine saving/consumption decision. It determines the level of G+S we can consume.

Irving Fisher:

$$i = \pi + r + r \pi \rightarrow \dot{i} = \pi + r$$

i = nominal interest rate, pi= inflation rate, r= real interest rate.

Capital gains may make people save less, as less savings are required to reach their optimal wealth-income ratio.

Capital losses may make people save more, as more savings are required to reach their optimal wealth-income ratio.

- **What has happened to household savings ratio in Australia**

It has been falling since the high of the early mid 1970's. Recently, it has risen slightly.

Australians have historically saved little → could be the little need for lifecycle saving due to generous government welfare payments.

- **What is national savings?**

$$S = Y - C - G$$

S= saving, Y= GDP, C= consumption, G= Government spending
(ie: income less spending on current needs)

Why do we not include I? Investment spending is used on purchasing capital plant and equipment, not satisfying current needs. Thus, it is not part of spending according to the definition of saving.

$$S = (Y - T - C) + (T - G)$$

\downarrow \downarrow
 Private sector saving Public sector saving

Note that T is NET TAXES- the difference between taxation revenue and taxation payments

$$S = \text{private savings} + \text{public savings}$$

$$\text{Private savings} = \text{Household savings} + \text{Business savings}$$

$$\text{Budget deficit} = G > T \text{ (dis-saving)} \quad \text{Budget surplus} = G < T$$

- Which sectors contribute to national savings?

- Importance of national savings

National savings provides the resources to allow investment to occur... If all income generated from current production was devoted to consumption expenditure, there would be no resources available to purchase capital goods.... Long term growth.

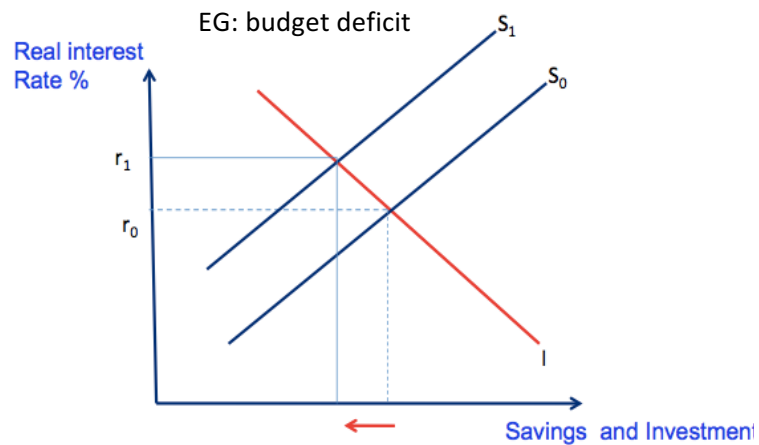
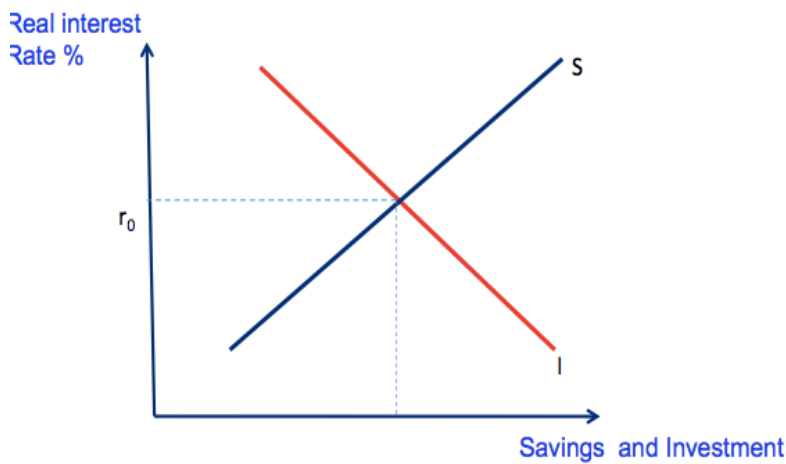
The lack of household savings is not necessarily a problem. **It is national savings, not household saving which determines the capacity of an economy to invest in new capital.** However, the fact that a large portion of private saving is saved by a small portion of the population introduces income inequality. Saving itself increases income inequality, because those who save have a greater wealth of assets, which then further allow them to enjoy greater income (ie: from shares etc). Conversely, those who save little have little wealth and thus, have little protection from setbacks such as inflation.

- Demand supply analysis of savings and investment

Demand- as the interest rate increases, the demand to invest reduces

Supply- as interest rate increases, the supply of national savings increases

Note: pay attention to the labels of the axis, and the labels of the curves



If r was higher than equilibrium r, then there would more people willing to lend funds than those who are willing to invest. To attract investors, lenders would lower their interest rates, until the equilibrium r. Here, demand for savings for investment equals the supply of savings.

Note: this model is for a closed economy.