

Principles of economics essay sample

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INTRODUCTION

The rate of consumption of an individual has to do with the level of income he/she possess. Current consumption level may be influenced and effected upon on the rate of interest, future expectation of income, present inheritance, and future consumption anticipation. Thus, the constraint or budget line of an individual consumption in two period is given and influenced by the individual's level of present income, future expected income and the prevailing interest rate..

In order for an individual to meet the demands for future consumption, he will increase his current saving level, i. e. if he believes the saving rate is high. This is especially, when the source of income is limited.

This essay takes a look at a case study of an individual with a single commodity to purchase from, and a lump um of inherited money, that is limited to increase, only through the interest rate of money saved. Indifference curve and mathematical notation are used to interpret his savings decision for the periods.

MATHEMATICAL REPRESENTATION OF THE INDIVIDUAL PROBLEM.

Since the individual' income I fixed and subject to increase by the interest he receives from bank on savings made, we ay: increase in income level is subjected to increase in interest rate.

Let the individual' income level be represented by ' y ', while interest rate be ' r ', consumption level of the ingle product be ' c ', and savings level be represented by ' s '.

'y' is a function of 'r'

i. e. $y = (f)r$

This means the greater the increase in interest rate on bank saving, the greater the level of income available to the individual.

Also, 'c' is a function of 'y'.

i. e. $c = (f)y$

The level of consumption is determined by the level of income. If there is increase in income level, the individual tends to consume more of the single commodity. Assuming there are substitutes for the commodity, and if the single- commodity is to be an inferior goods, the individual would have decreased his consumption level of the inferior product as his income increase.

Since there are two period; the individual would be concern with his current consumption and saving level, and his future consumption and saving level.

Using inequality mathematical tool to compare this problem; if the individual has more preference for current consumption then:

$c > s > 0$

The consumption level of the individual will be greater than the level of savings, of the individual is more inclined to current consumption. But saving cannot be zero because the individual knows that he has no other source of

income. Hence, he will be bound to save some aspect, even if it is lesser than what he would save if he has more preference for future consumption.

On the other hand, if the individual has more preference for future consumption than for current consumption, then

$$0 < c < s$$

Here, the savings level would be greater than the consumption level. This is so as a result of the individual inclination to increase future consumption level as a result of the increase in income level through accumulated interest rate.

Also, if the interest rate is high, savings will increase, and consumption level will decrease.

$$\text{Increase in 'r' = } s > c$$

This will be true if the individual has more preference for future consumption than for current consumption.

USING AN INDIFFERENCE CURVE TO ANALYSE THE INDIVIDUAL'S SAVING DECISION.

Indifference curve is a graph that shows how an individual or a firm at the microeconomic level, combines two commodities and how his preference is made at any given point along the indifference curve line. Using indifference curve to analyze the saving decision of the individual in the case study, we see that the activity takes place in two periods, i. e. the current and future periods.

According to Rugby (2005), the constraint or budget line in such given instance in two- period consumption model represents the possible levels of consumption in the individual's level of present income; future expected income and the prevailing interest rate ' r '. This budget lines has a slope equal to $-(1+r)$.

The behaviour of the individual in this case study will determine how his saving decisions are made. If the individual ha more preference for future consumption than for current consumption, then more amount will be saved.

The graph below illustrates this:

Future consumption

(Net savings)

P

R Slope= $-(1+r)$

0

Current consumption

The diagram above shows that the individual has a strong preference for future consumption than for current consumption. In the current time period- current income would exceed current consumption. The savings and accumulated interest would be used for future. Point ' P' shows the fact that if current consumption equals current income then future consumption and income must also be equal.

On the other hand if the individual has more preference for current consumption than for future consumption, the graph below is used to illustrate his savings behaviour under this giving condition:

Future consumption

Slope= - (1+r)

P (Net borrowings)

R

0

Current consumption

The graph shows that the individual tends to save little or resort to borrowing so as to meet his current consumption level. In this instance the individual has more preference for current consumption. So his savings for this period will be little, while he may resort to borrowing if he has the opportunity of this.

CHARACTERISTICS OF THE INDIVIDUAL SAVING DECISION

Given the condition the individual finds himself, he will definitely result to saving of some part of the inherited sum. This is so, since he has no other means of increasing his income except through the interest on his savings. Therefore, he will be conscious of the fact that if he consumes all his money within the current period he will be left with no income. Hence, mathematically, we say his savings will be greater than zero

$$s > 0$$

Also, the saving level of the individual cannot be equal to the current income he has. since he will definitely consume part of it at the current period.

Therefore current income is greater than savings level.

$$y > s > 0$$

In other words, current income cannot be equal to savings

$$y = s.$$

HOW SAVINGS WOULD RESPOND TO INCREASE IN THE INTEREST RATE PAID

As the income level increases as a result of increase in the interest rate on savings, at this period the individual tend to increase his level of savings.

Future consumption

(Net savings)

Current consumption

The graph shows there is a rightward shift in the indifference curve, showing that there is increase in savings level as a result of increase in the interest rate on saving.

REFERENCE

Rugby, Douglas A. (2005) “ The Two Period Consumption” (http://www.digitaleconomist.com/tpc_4020.html) (9th December, 2005).

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