Unit 4: Understanding Consumption, Saving, and Investment

Consumption

What is Consumption?

- Consumption refers to the spending by households on goods and services to satisfy their current needs and wants. It is a significant component of a country's GDP.
- **Disposable Income (Yd):** The most crucial factor influencing consumption is disposable income, which is the income households have left after paying taxes. The sources emphasize that as disposable income rises, consumption tends to increase, but not necessarily at the same rate.

Key Concepts Related to Consumption

- **Average Propensity to Consume (APC):** The proportion of disposable income that households spend on consumption. It is calculated as: **APC = Total Consumption (C) / Total Disposable Income (Yd)**.
- **Marginal Propensity to Consume (MPC):** The change in consumption spending resulting from a change in disposable income. It is calculated as: **MPC = Change in Consumption (ΔC) / Change in Disposable Income (ΔYd)**.
    - MPC demonstrates how much of each additional unit of income households will spend on consumption.
    - For example, if MPC is 0.8, and a household's income increases by Birr 100, they will spend Birr 80 of that increase on consumption.
- **Factors Influencing Consumption:**
    - **Interest Rates:** Higher interest rates generally encourage saving and discourage borrowing, potentially leading to a decrease in consumption.
    - **Wealth:** Households with higher levels of accumulated wealth tend to consume more, even if their current income remains the same.
    - **Expectations:** Consumer confidence and expectations about future economic conditions can significantly impact spending decisions. If households are optimistic about the future, they are more likely to increase their consumption.

Saving

What is Saving?

- Saving represents the portion of disposable income that households do **not** spend on consumption. In essence, it is the act of postponing current consumption for future use.

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Key Concepts Related to Saving

- **Average Propensity to Save (APS):** The proportion of disposable income that households save. It is calculated as: **APS = Total Saving (S) / Total Disposable Income (Yd)**.
- **Marginal Propensity to Save (MPS):** The change in saving resulting from a change in disposable income. It is calculated as: **MPS = Change in Saving (ΔS) / Change in Disposable Income (ΔYd)**.
    - MPS indicates how much of each additional unit of income a household will save.
    - For example, if the MPS is 0.2, and income rises by Birr 100, the household will save Birr 20 of that increase.
- **Important Relationship:** The sources highlight that the sum of APC and APS is always equal to 1, and the sum of MPC and MPS is also always equal to 1. This reflects the fact that disposable income is either consumed or saved.
- **Factors Influencing Saving:** Many of the factors influencing consumption also impact saving, but in the opposite direction.
    - **Income Levels:** Generally, saving tends to rise as income increases, although the rate of increase may vary.
    - **Interest Rates:** Higher interest rates often incentivize saving as they provide a higher return on saved funds.
    - **Wealth:** Households with more wealth may save less as they feel more financially secure.
    - **Taxes:** Higher direct taxes on income can reduce disposable income, leading to lower saving levels.
    - **Individual Behaviour:** Personal characteristics and attitudes towards saving also play a role. For example, individuals who are more future-oriented tend to save more.

The Role of *Iqub* in Ethiopian Saving Culture

The sources provide an interesting example of a traditional saving mechanism in Ethiopia called "iqub".

- **What is Iqub?** Iqub is an informal, community-based saving and credit system where a group of individuals regularly contribute a fixed sum of money into a collective pool. Each member then takes turns receiving the entire pool, providing a lump sum that can be used for consumption or investment.
- **Significance:** Iqub demonstrates the importance of saving in Ethiopian culture and highlights a community-driven approach to financial management, particularly in the absence of formal banking systems.

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Investment

What is Investment?

- Investment, in an economic context, involves acquiring goods not for immediate consumption but to generate wealth in the future. This typically involves businesses purchasing capital goods, such as machinery and equipment, to increase production capacity.

Types of Investment

- **Induced Investment:** Driven by changes in demand for goods and services. For example, if consumer demand for smartphones increases, a company might respond by investing in new factories and equipment to increase production.
- **Autonomous Investment:** Investment that is not directly related to changes in current demand. This might include investments in infrastructure projects or research and development, often driven by government policies or long-term economic factors.

Factors Influencing Investment

- **Interest Rates:** Interest rates represent the cost of borrowing money. Higher interest rates generally make investment less attractive as they increase the overall cost of borrowing.
- **Expected Returns:** Businesses make investment decisions based on the potential profits they expect to earn from those investments. Factors influencing expected returns include:
    - **Economic Growth:** Expectations of strong economic growth often lead to higher investment as businesses anticipate increased demand for their products.
    - **Technological Advancements:** New technologies can create new investment opportunities or make existing investments more profitable.
    - **Business Confidence:** A positive and stable business environment, with clear regulations and low risks, encourages investment.

The Accelerator Theory

- This theory, mentioned in the sources, suggests a strong link between consumption and investment. When consumption spending rises, it can lead to a disproportionately larger increase in investment. For example, even a small increase in demand for a product might require a company to invest heavily in a new factory to meet that demand.

Investment and Economic Growth

Investment is a crucial driver of long-term economic growth. By increasing the stock of capital goods, investment expands a country's productive capacity, leading to higher output, income, and employment in the long run.

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The Importance of the Ease of Doing Business (EoDB)

- **What is the EoDB?** The Ease of Doing Business (EoDB) index, mentioned in the context of Ethiopia's investment climate, measures the regulations and conditions that impact businesses operating within a country. A higher EoDB ranking suggests a more business-friendly environment.
- **Significance for Investment:** The EoDB can influence investment decisions. Countries with a higher EoDB ranking are often more attractive to both domestic and foreign investors. Improving the EoDB by streamlining regulations, reducing bureaucracy, and enhancing transparency can boost investment and promote economic growth.

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