

ECON 5103 Unit 4, Video 2
Individual behavior, part II

Saving vs. Spending

Things that affect this decision

Consumer confidence

Expectations of future prices

Interest rates on savings & on loans

5103-unit4-2 Page 1

Intertemporal budget constraint: An equation that ~~describes how~~ a person allocates his earnings over his lifetime

Example: Biff lives only for 2 years. During the first year he earns \$9000. During the second year he is retired. During year 1 he can choose to save some of his earnings and earn interest of 5%; he can spend his savings & interest when he's retired.

Some options facing Biff:

1. Spend the whole \$9000 in the first year, having no money to spend in year 2.
2. Save the whole \$9000 in the first year, having \$9000 + interest to spend--\$9450--in the second year
3. Save \$4500 in the first year, having \$4500 + interest to spend in the second--\$4725

5103-unit4-2 Page 2

An equation representing Biff's intertemporal budget constraint:

"C1" is "total spending in year 1"

"C2" is "total spending in year 2"

$$C2 = (9000 - C1) \times (1 + .05)$$

Biff's
earnings in
year 1

Biff's
savings
in year 1

Interest rate that Biff
earns on his savings.