LIFE CYCLE, INDIVIDUAL THRIFT AND THE WEALTH OF NATIONS

by

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Introduction

This paper provides a review of the theory of the determinants of individual and national thrift that has come to be known as the Life Cycle Hypothesis (LCH) of saving. Applications to some current policy issues are also discussed.

Part I deals with the state of the art on the eve of the formulation of the LCH some 30 years ago. Part II sets forth the theoretical foundations of the model in its original formulation and later amendment, calling attention to various implications, distinctive to it and, sometimes, counter-intuitive. It also includes a review of a number of crucial empirical tests, both at the individual and the aggregate level. Part III reviews some applications of LCH to current policy issues, though only in sketchy fashion, as space constraints prevent fuller discussion.

I. *Antecedents*

*(*1) *The role of thrift and the Keynesian revolution*

The study of individual thrift and aggregate saving and wealth has long been central to economics because national saving is the source of the supply of capital, a major factor of production controlling the productivity of labor and its growth over time. It is because of this relation between saving and productive capital that thrift has traditionally been regarded as a virtuous, socially beneficial act.

Yet, there was a brief but influential interval in the course of which, under the impact of the Great Depression, and of the interpretation of this episode which Keynes suggested in the *General Theory* [1936], saving came to be seen with suspicion, as potentially disruptive to the economy and harmful to social welfare. The period in question goes from the mid '30s to the late '40s or early '50s. Thrift posed a potential threat, as it reduced one component of demand, consumption, without systematically and automatically giving rise to an offsetting expansion in investment. It might thus cause "inadequate" demand - and, hence, output and employment lower than the capacity of the economy. This failure was attributable to a variety of reasons including wage rigidity, liquidity preference, fixed capital coefficients in production and to investment controlled by animal spirits rather than by the cost of capital.