Chapter 26: Saving, Investment, and the Financial System
Principles of Economics, 8th Edition
N. Gregory Mankiw
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1. Introduction
   a. Financial system is the group of institutions in the economy that help to
      match one person’s saving with another person’s investment. P. 542.
   b. *This chapter presents a long term view of the economy.*

2. Financial Institutions in the U.S. Economy
   a. Financial markets are financial institutions through which savers can
      *directly* provide funds to borrowers. P. 542.
   b. The bond market
      (1) Bond is a certificate of indebtedness. P. 543.
   ii. The stock market
      (1) Stock is a claim to partial ownership in a firm. P. 543
   c. Financial intermediaries are financial institutions through which savers can
      *indirectly* provide funds to borrowers. P. 544.
      i. FYI: Key Numbers for Stock Watchers, P. 545.
      ii. Banks
      iii. Mutual funds are institutions that sell shares to the public and use
          the proceeds to buy a portfolio of stocks and bonds. P. 545.
          (1) Help small investors diversify.
          (2) Professional management.
              (a) However, on average indexed funds do better than
                  managed funds.
   d. Summing up

3. Saving and Investment in the National Income Accounts
   a. Some important identities
      i. In an open economy, GDP(Y) = C + I + G + NX.
      ii. In a closed economy, GDP(Y) = C + I + G.
      (1) Since S = Y - C - G, then S = I.
          (a) *Think of savings as a leakage out of the circular flow
              and investment as an injection into it.*
      (2) Alternatively, S = (Y - C - T) + (T - G).
      iii. National saving (saving) is the total income in the economy that
          remains after paying for consumption and government purchases (S
      iv. Private saving is the income that households have left after paying
          for taxes and consumption (Sp = Y - T - C). P. 548.
      v. Public saving is the tax revenue that the government has left after
          paying for its spending (Sp = T - G). P. 548.
      vi. Budget surplus is an excess of tax revenue over government
          spending. P. 548.
      vii. Budget deficit is a shortfall of tax revenue from government
spending. P. 548.

b. The meaning of saving and investment is based on the national income accounts.

4. The Market for Loanable Funds is the market in which those who want to save supply funds and those who want to borrow to invest demand funds. P. 549

a. Supply and demand for loanable funds
i. Saving is the source of the supply of loadable funds.
ii. Investment is the source of the demand for loadable funds.
iii. **Figure 1: The Market for Loanable Funds.** P. 550.
iv. *These are funds available to the private sector.*

b. *The following examples are an excellent introduction to thinking macroeconomically.*

c. Policy 1: Saving Incentives
i. A consumption tax would encourage saving lowering the interest rate in a closed economy.
ii. The effect is more complicated in an open economy in which interest rates are more or less fixed.
   (1) In that case, an increase in domestic saving
      (a) temporarily reduces domestic interest rates,
      (b) which cause a shift out of dollars
      (c) reducing the exchange rate
      (d) which encourages exports and
      (e) discourages imports so that
      (f) net exports increase.
   (2) **Figure 2: Saving Incentives Increase the Supply of Loanable Funds.** P. 552.

d. Policy 2: Investment Incentives
i. An increase in investment tax credits encourages investment which increases the domestic interest rate in a closed economy.
   (2) **Figure 3: Investment Incentives Increase the Demand for Loanable Funds.** P. 553.

e. Policy 3: Government Budget Deficits and Surpluses
i. An increase in the government deficit reduces national saving that increases the interest rate in a closed economy.
   (1) Some crowding out of domestic investments will occur.
   (2) **Figure 4: The Effect of a Government Budget Deficit.** P. 554.
   (3) Crowding out is a decrease in investment that results from government borrowing. P. 562.
   (4) **Case Study: The History of U.S. Government Debt, P.**
(a) This is only based on cash based accounting as based on accrual accounting the debt is much larger now.

(b) The primary cause of fluctuations in government debt is war.

(c) Figure 5: The U.S. Government Debt. P. 556.

(5) FYI: Financial Crises, P. 558.

5. Conclusion

6. Summary