CHAPTER TWO
LITERATURE REVIEW

This chapter reviews the literature in its main areas along with a summary as a guideline to the questionnaires: (1) Theory of consumption and savings, (2) The Life Cycle Theory, (4) Saving in Thailand, and (4) summary.

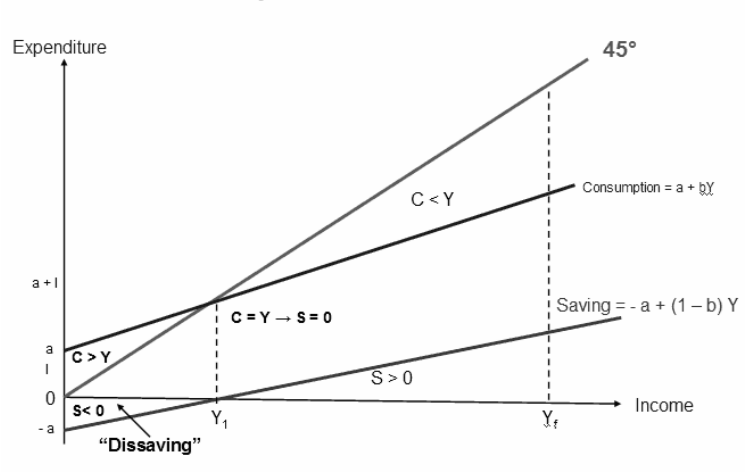
2.1 THEORIES OF CONSUMPTION AND SAVINGS

There are two theories which are used to describe consumption and saving behavior.

2.1.1 Theory of Consumption and Savings by Keynes

John Maynard Keynes (1883-1946), a famous economist, wrote *"General Theory of Employment, Interest and Money"* and it was published in 1936. The most important idea influencing personal consumption was an individual's income. Individual income was described to be the most systematic determinant of individual saving. Keynes began with a very simple statement: When income goes up, consumption increases, but not as much as income.

Keynesian Model



Therefore, one key idea to be raised from this theory was saving. If it assumes there are only two sector economies (such as without government), all money not spent on consumption will be saved by the individual. Keynes reasoned there is a level of consumption that is necessary for individuals to stay alive such as expenditure on food, an autonomous element. When the amount of consumption is above income (above 45°), it means the individual must use money from saving. When consumption equals income, there is no saving or negative, whereas with a higher income, the individual will save any surplus income and not consume it.

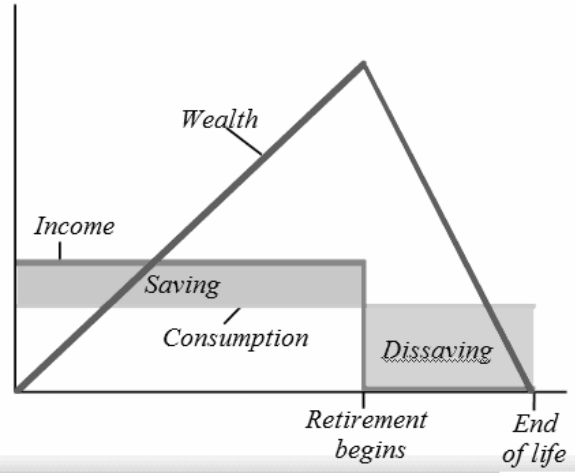
Keynes predicted that the average tendency to save of the average household would increase when they reach a higher income level. Individuals with a low income cannot save because of expenses on necessary goods.

2.1.2 The Life-Cycle Theory

Franco Modigliani (1918-2003) presents the life-cycle model to explain the way that people divided their income into spending and saving. The theory based on the idea that people make intelligent choices about how much they want to spend at each age, and is limited only by the resources available over their lives. The model links the consumption plans, income, and income expectation since childhood, through work years, into retirement, and until death.

The saving decision is driven by preferences between present and future consumption. Individual estimates of the income which the household receives over time, the sequence of optimal consumption and saving decisions over the entire life can be computed. The model provides a single framework which integrates allocation at many different frequencies then assesses the model by reexamining the evidence for smoothness within the year, at business cycle frequencies, or over the working life. By building up and running down assets, people can make provision for their consumption patterns to their needs at different ages, independently of their incomes at each age.

Life-Cycle Model



The shape of income over the life cycle starts with low income during the early years of working life then it increases until reaching a peak before retirement. While during retirement, the pension income is lower. To avoid the sharp drop at the point of retirement, individuals will save their income during their working life and spend during retirement. From this model, which presumes that consumption is distributed over time, it implies that an individual during working his or her period, will build up a stock of wealth which is consumed during old age.

The life-cycle assumes the individual maximizes the utility from their entire life-cycle consumption. Therefore, the consumption must be continuous, even though income through the life-cycle stops. At the same time, savings are changed to consumption during the retirement period.

2.2 RELEVANT RESEARCH: SAVINGS IN THAILAND

Apitchaya Nguanbanchong (2004) investigated the factors that affected saving behavior by describing how they handled savings. It was concluded that the following factors influence people to consume and save. *First,* individual income was an important determinant of saving. Higher income of wives and husbands significantly increases saving, whereas the individual characteristics such as age, level of education, number of children were not significant. *Second,* the level of saving patterns is based on perceived interest and risk. Thai women tended to save more

money than Thai men. They saved money for children's education and other expenses. Moreover, women tended to use informal saving institutions whereas men tended to participate in formal saving groups.

Malinee Tengumnuay (1981) studied the variables affecting saving behavior in Thailand. It was found that the people working in urban areas, saved their money because they had more opportunities to save through financial institutions, whereas rural areas saving was lower due to fewer alternatives and possibilities in consumption. The result in relating the age structure to the saving behavior was contrary to expectations, the older in the central region tended to save less. However this effect was due to the larger household size as the age class increased. Household size was a significant factor in determining saving. The larger household size was related to lower saving.

Kiatipong Ariyapruchya, Wilatluk Sinswat, and Nalin Chutchotitham (2007) describe the risk behavior of household and the key role of the financial sector which helps households can access new types of financial instruments. Rather than avoid the risk of economic fluctuation, households choose to pursue risky economic ventures. The households have learned how to live with risk through managing it and bearing the consequences. A well-functioning financial sector can help household manage risk and accumulate wealth. However, it also brings higher risks. Excessive borrowing brings households into trouble and possible insolvency.