

The paradox of the thrift economics essay



**ASSIGN
BUSTER**

The theory of paradox of thrift is the idea that saving instead of spending can cause or deepen a recession. According to John Maynard Keynes, consumer spending is beneficial because one person's expenditure is another person's income. Therefore, an increase in savings would mean that businesses lose out on revenue and have to lay off employees who are then unable to save. As a result, increase in individual savings would reduce the total saving rate. On the other hand, some economists argue that, savings can be beneficial to an economy. If the society decides to save in a bank, the banks would loan that money to firms and who in return will invest into capital, producing a positive multiplier effect. It just depends which phase of the economic cycle the economy is operating. During low demand market conditions like at the moment, saving is beneficial for the one who saves, but of little use to the overall economy, this is known as the fallacy of compositions.

C: UsersPawanjeetDownloads20121208_165525. jpg

In the Paradox of Thrift, household and producers reduce their expenditure in anticipation of a future recession. It is referred as "paradox" because its behavior which seems beneficial is actually detrimental to the economy. It's beneficial for the individual who decides to save, but the society as a whole experiences economics problems. Assume there was an exogenous increase in planned savings due to future expectations of the UK economy. This means that the autonomous savings will increase; hence the saving function will have parallel shift upwards. A rise in the thriftiness will lead to a reduction in national income (Y_1 to Y_2), consequently savings will decrease from B to A. Furthermore, due to the shift, $S > I$ which implies that $Y > AD$,

<https://assignbuster.com/the-paradox-of-the-thrift-economics-essay/>

therefore there will be excess supply of goods. The result will be paradoxical because an increase in saving will eventually translate into a reduction in national income. C: UsersPawanjeetDropboxPhotos20121209_172334. jpg

The lower consumption will discourage firms from investing, if investment falls, the J line will shift downwards. There will be a further multiplied fall in national income. Due to the negative speculation of the economy, let's assume that the marginal propensity to withdraw is now 0.75 and marginal propensity to consumption (domestic goods) is also 0.25. Consider that the initial investment falls from 100 to 50 (million) in the economy. Therefore, as firms reduce investment, workers will be made redundant. These workers will have no spending money, therefore causing other businesses to experience a decline in customers. When wages are received, 0.75 would be withdrawn and only 0.25 will be spent on domestic goods. The reduction in consumption would generate further losses for firms, generating 12.5 million in losses for firms from the initial 50 million. When this is received by households in terms of wages, 0.75 will be withdrawn and 0.25 will be spent. There will be a further decrease in national income by a further 3.125 million. Therefore each time we go round, national income will decrease due to the multiplier. As a result, the economy will contract and firms will experience heavy losses in revenue, resulting in several closures. According to the consumption function, as income decreases so do savings, therefore more savings will lead to ultimately and paradoxically less savings. C:

UsersPawanjeetDropboxPhotos20121208_182123. jpg

C: UsersPawanjeetDropboxPhotos20121208_201542. jpg

The theory behind the paradox of thrift has been widely criticised. Firstly, it's a theory and subjective, therefore it's not a stated fact. Secondly, given the example above, the paradoxical result may not occur if an increase in savings will lead to simultaneous increase in planned investment.

Consequently, both the investment and the saving function will shift upwards; therefore national income will not be affected. Furthermore, when the multiplier becomes smaller due to higher marginal propensity to save, the IS Curve will shift from IS to IS1. This will influence aggregate demand to shift leftwards; hence there will be a reduction in prices. As price decrease, this will shift the LM curve to the right, forming a new equilibrium.

Consequently, we will have lower interest rates and prices. Therefore, when interest rates fall this will influence firms to invest and when prices decrease this will trigger a rise in demand again, so the theory of the paradox of thrift is contradictory.

Economist argues that saving can translate to investment, therefore in a recession, saving can be beneficial. Savings will allow these investments to be financed without problem of interest rates or inflation. Suppose an individual decides to save £10, 000 in a saving account. Consequently, the bank would lend money to a firm who would spend it to expand or to the government by purchasing treasuries. When the fund is given to firm, they will invest into capital that would boost total output. Therefore, theoretically, an increase in savings will allow a higher growth in potential GDP, especially if the investment is in new technologies.

During 1950s, Americans put away more than 9% of their income. Their savings translated into stocks and bonds and formed a pool of capital

<https://assignbuster.com/the-paradox-of-the-thrift-economics-essay/>

investment. They experienced a golden era of productivity and growth, leading towards the 1990s boom. Although this changed, in the mid-1980's, this is because credit become easily accessible, therefore people were not saving for future consumption, because they could use to borrowing. By the late 2000s, the savings rate plunged to less than 1%. *

Theoretically, using the GDP equation (closed economy) we derive that
saving= investment

$$Y = C + I + G \quad (1)$$

$$I = Y - C - G \quad (\text{Rearrange to make } I \text{ the subject})$$

$$S \text{ (private)} = \text{amount produced (Y) + transfer payment from the government (TR) - consumption (C) - Taxes (T)}$$

$$S \text{ (public)} = T - G - TR$$

$$\text{Total saving in the economy will be } s \text{ (public)} + s \text{ (private)} = T - G - TR + Y + TR - C - T = S$$

$$\text{Therefore, total saving in the economy} = Y - G - C$$

Sub into equation (1)

$$S = C + I + G - G - C$$

$$\text{Therefore, } S = I$$

This shows that the total amount of savings in the economy is equal to investment

Source: Gfk nop 2012

In the Wall Street Journal, the writer states “ savings would translate into more investment and faster growth.” This view has been supported in the work by Fazzari (2007). On the contrary, what will happen if the firm does not invest into capital? What will happen when banks do not give loans to firms? The statement that saving= investment is contradictory. It does not necessarily mean that every pound saved will be invested. Investment does not only depend on household savings; it could be animal spirit, business confidence, aggregate demand and cooperation tax that could influence investment. Therefore it’s only an assumption and not a stated fact.

Furthermore, higher savings would mean there would be less consumer expenditure, therefore aggregate demand for goods and services would weaken, hence investment into capital goods could occur only in the long run. Moreover, during low market demand conditions like the current one, firms may not want to invest, if there is not demand for credit, the banks have no place to lend the money. In the UK economy, consumer confidence decreased to -31 in March and it’s to further reduce to due to planned austerity. Therefore investments are unlikely, regardless of any increase in savings.

Furthermore, during boom in the economy cycle, where inflation is inevitable, increased savings can help. C:

UsersPawanjeetDropboxPhotos20121212_140639. jpg

Consider an overheated economy; where there is little spare capacity in the economy, therefore an increase in aggregate demand will lead to

<https://assignbuster.com/the-paradox-of-the-thrift-economics-essay/>

subsequently only to an increase in prices. The government will try to depress aggregate demand and economic activity. In other words, the government will try to encourage savings to hamper consumption in the short run. Consequently, this will lead aggregate demand to have a parallel shifts inwards, reducing prices levels from p_1 to p_2 . Reduced inflation provides certainty towards consumers and businesses, who will be able to make long term plans due to certainty that there would less chance of their money losing its purchasing power. On the contrary, there will be a cost of reducing inflation as it will impact upon low income earners, decline in economic growth and will result in higher unemployment.

As shown from the macro perspective, an increase in saving for the economy as a whole may lower aggregate demand and initially reduces output, income and probably investment. So would savings be ever desirable? Yes, during an overheated economy, increases in savings can help reduce consumption, which would therefore reduce prices levels. Furthermore, as some argue, increases in savings may likely to influence investment levels. It just depends which phase of the economic cycle the economy is operating. During low demand market conditions like at the moment, saving are beneficial for the one who saves, but of little use to the overall economy.