ANALYSIS OF THE PARADOX OF THRIFT DURING TWO GREAT RECESSIONS

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Abstract - The argument begins from the observation that in the condition of equilibrium, total income must be equal to total output. Income has a direct effect on saving. Other things being equal, an increase in the autonomous component of saving, will move the equilibrium point at which income equals output to a lower value, thereby inducing a decline in saving that may more than offset the original increase. Keynes rejected the classical economy theories that 1. Output and prices will eventually return to a state of equilibrium. He was not as optimistic about the natural equilibrium of the market. He believed the government was in a better position than market forces when it came to creating a robust economy. 2. Cutting of wages can restore full employment, by arguing that employers will not add employees to produce goods that cannot be sold because demand is weak. In this form it represents a prisoner's dilemma as saving is beneficial to each individual but deleterious to the general population. This is a "paradox" because it runs contrary to intuition. However, exercising thrift may be good for an individual by enabling that individual to save for a "rainy day", and yet not be good for the economy as a whole. Keynesians Said that consumption, or spending, drives economic growth. Thus, even though it makes sense for individuals and households to cut back consumption during tough times, this is the wrong prescription for the larger economy. A pullback in aggregate consumer spending might force businesses to produce even less, deepening the recession. This disconnect between individual and group rationality is the basis of the savings paradox.

Keywords - Paradox, Thrift, Depression, Investment, Employment

I. RESEARCH BACKGROUND

The first conceptual description of the Paradox of Thrift may have been given by Bernard Mandeville in his famous books “Private Vices, Publick Benefits” (1714) “The Fable of the Bees” (1732). Mandeville argued for increased expenditure as the key to prosperity, rather than savings. Keynes had suggested that Adam Smith was referring to this passage when he wrote "What is prudence in the conduct of every private family can scarce be folly in that of a great Kingdom." John M. Robertson (1892)"collective attempts to save yield lower overall savings" book The Fallacy of Saving, p. 131–2 Keynes distinguished between investment/ business activity and savings in his Treatise on Money (1930). While the paradox of thrift was popularized by **Keynes**, and is often attributed to him, Keynes credited Mandeville for the concept in his book “The General Theory of Employment, Interest and Money” (1936). The concept of paradox of thrift was popularized by the him during the 1930s in an attempt to understand the Great Depression.

The theory is referred to as the "paradox of thrift" in Samuelson's influential Economics of 1948, which popularized the term.

II. OBJECTIVES

In this paper following objectives have been identified:
1) To study the practicality of Paradox of thrift.
2) To study the effects of saving money at the time of recession.
3) To study if saving is good or bad for the economy.
4) To Analyse and study the impact of saving during two historical recessions.

III. STATEMENT OF THE PROBLEM

Since the start of human civilisation, It was believed that to keep consumption level at the minimum is a virtue, but the final effect of keeping consumption in check were not realised. It was considered that saving is good habit because a penny saved today will bring happiness. But The Paradox of Thrift (saving) tried to explain that personal savings are a net drag on the economy during a recession.

This theory relies on the assumption that prices do not clear or that producers fail to adjust to changing conditions, contrary to the expectations of classical microeconomics. According to Keynes that if everyone tries to save an increasingly larger portion of his or her income, they would become poorer instead of richer because the economy will slow down due to the reduction in demand and the very same people would lose their jobs. This theory, however, applies mainly to Keynesian economics where increased savings represent a diminishing circular flow of income.

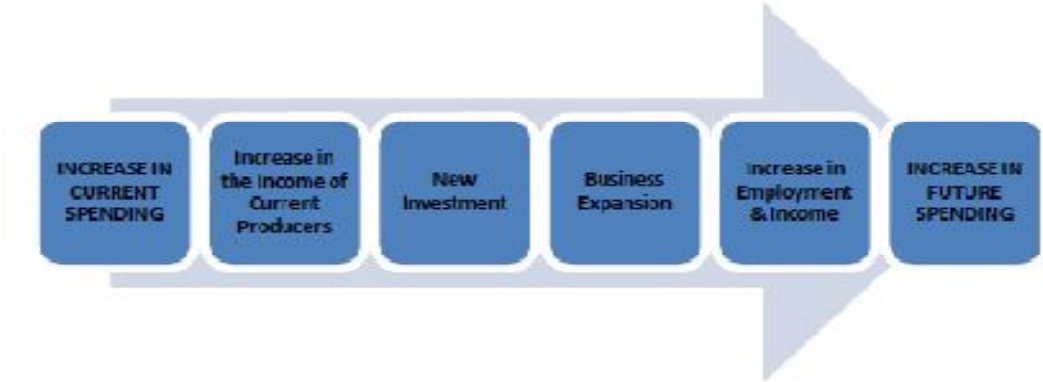
The Paradox of Thrift, explains that at the time of economic recession individuals try to save more and more, which is actually very harmful for the country as investments give lower returns than normal. essentially leads to a fall in aggregate demand and hence in economic growth. He once said that such a mass increase in savings eventually hurts the

economy as a whole. Keynes was in favour to increase government expenditures and lower taxes to stimulate demand and pull the global economy out of the depression.

IV. CIRCULAR FLOW

Keynes helped revive the so-called "circular flow" model of the economy. This theory says an increase in current spending drives future spending. Current spending, after all, results in more income for current producers. Those producers rationally deploy their new income, sometimes expanding business and hiring new workers, each of whom earns a new income which, in turn, may be spent.

In order to increase current spending, Keynes argued for lower interest rates to lower current savings rates. If low interest rates do not create more borrowing and spending, Keynes said the government could engage in deficit spending to fiVll in the gap. He was also in favour to increase government expenditures and lower taxes to stimulate demand and pull the global economy out of the depression.



V. PARADOX OF THRIFT AND THE GREAT DEPRESSION

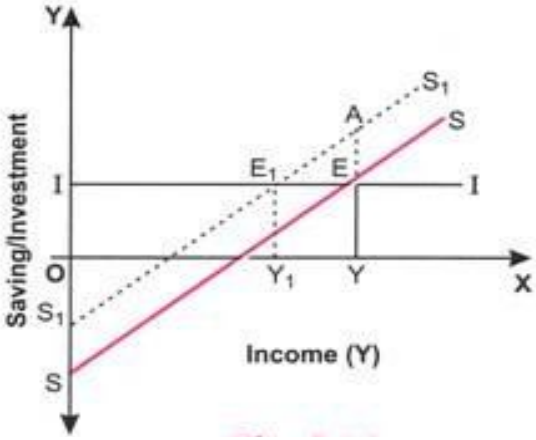
The Great Depression seemed to counter the assumptions given by classical economists. Output was very low and unemployment remained high during this time. The Great Depression inspired Keynes to think differently about the nature of the economy. With the help of these theories, he established real-world applications that could have implications for a society in economic crisis. He said that lower prices & cost can increase the investment in new projects but poor business conditions may cause companies to reduce capital investment, rather than take advantage of lower prices to invest in new plants and equipment. This would also have the effect of reducing overall expenditures and employment.

Keynes was highly against the British government at the time. The government cut welfare spending and raised taxes to balance the national books. Keynes said this would not encourage people to spend their money, thereby leaving the economy unstimulated and unable to recover and return to a successful state. Instead, he proposed that the government spend more money, which would increase consumer demand in the economy.

This would in turn lead to an increase in overall economic activity, the natural result of which would be deflation and a reduction in unemployment. Keynes also criticized the idea of excessive saving unless it was for a specific purpose such as retirement or education. He saw it as dangerous for the economy because the more money sitting stagnant, the less money in the economy stimulating growth. This was another of Keynes' theories geared toward preventing deep economic depressions. The magnitude of the multiplier given by Keynes is directly related to the marginal propensity to consume. It means spending from one consumer becomes income for another worker. That worker's income can then be spent and the cycle continues. According to Keynes individuals should save less and spend more, raising their marginal propensity to consume, to effect full employment and economic growth. In this way, one rupee spent in fiscal stimulus eventually creates more than one rupee in growth. This theory was one of the dominant paradigm in academic economics for decades.

VI. EXAMPLE

We can understand the paradox of thrift this way: Assume everybody earns Rs. 1,000 of income. They save 50% (Rs.500) and spend the rest (Rs.500). This means everybody is spending Rs.500, which supports demand for products, which in turn creates jobs, encourages entrepreneurship, and generates tax revenue for the government. But if everybody decides to save more for retirement. They start saving Rs.750 of their Rs.1,000 and spending only Rs.250. Suddenly, there is a drop in the demand for goods and services. Businesses can't make a profit, and so they lay off workers, which raises unemployment and lowers the tax revenue to the government. Now, The unemployed people because of no income, stop spending altogether, which worsens the problem even more. The whole thing continues on a downward spiral. Paradox of thrift refers to contrasting implications of savings to households and to economy as a whole. Saving is treated as a virtue by households as they provide a protective umbrella against bad spells but same is treated as a vice by the economy as it retards the process of income generation. Prior to Keynesian economics, classical economic thinking held that cyclical swings in employment and economic output would be modest and self-adjusting. According to this classical theory, if aggregate demand in the economy fell, the resulting weakness in production and jobs would precipitate a decline in prices and wages. A lower level of inflation and wages would induce employers to make capital investments and employ more people, stimulating employment and restoring economic growth. The depth and severity of the Great Depression, however, severely tested this hypothesis.If all the people of an economy increase the proportion of their saving (MPS), the value of the saving in the economy will either decline or remain unchanged. Let us discuss with the help of this figure.



In this figure, SS is saving curve while II is investment curve. Economy is in the condition of equilibrium when SS = II. At the equilibrium point E level of income is OY. If society decides to become thrifty by reducing consumption and increasing saving by AE. As a result, saving curve shifts upward to S_1S_1 intersecting investment curve II at E1. This will result in increase in unplanned Inventories, Less Production and Less Employment and the investment level remains the same. But level of income falls from OY to OY_1.

The decline in level of income shows the paradox of thrift as a reverse process of multiplier has worked on reducing consumption expenditure. In fact increased saving is a withdrawal of money from circular flow.

Answer is very simple: as the marginal propensity to save increases, total revenue for firms falls which stunts economic growth and can prolong the downturn, It makes it clear that most economic recessions are demand-based.

VII. PARADOX OF THRIFT IN THE GREAT RECESSION OF 1930

In the great depression of the 1930s, GDP fell, unemployment rose and the UK experienced a long period of deflation. In response to this disastrous economic situation, mainstream economists were at a loss as how to respond. Such a lengthy period of disequilibrium didn't sit well with Classical theory which expected markets to operate smoothly and efficiently.

The National government did approve the policy of cutting the unemployment benefits. The rationale was that in times of a depression the govt should set an example by reducing its debt. This actually inspired people to increase their savings in the hope that it would help the economy.

By reducing benefits they further reduced consumer spending and aggregate demand. This made areas of high unemployment even more impoverished. When people saved rather than spent their money it just made the recession worse.

J.M. Keynes once said that this 'paradox of thrift' was pushing the economy into a prolonged recession. He argued that in response to higher private saving, the government should borrow from the private sector and inject money into the economy. This government borrowing wouldn't cause crowding out because the private sector were not investing, but just saving.

In the UK and US Keynes was largely ignored until after the war and as a consequence the UK economy experienced high levels of unemployment for the remainder of the decade.

VIII. THE PARADOX OF THE PARADOX OF THRIFT

The Great **Recession**—which officially lasted from December 2007 to June 2009—began with the bursting of an 8 trillion dollar housing bubble. The

resulting loss of wealth led to sharp cutbacks in consumer spending. Americans have started to save again, hope it will last.

WHAT will the global economy look like without the consumption-mad American? In response to the recession Americans have started saving more and spending less. In many respects that's a positive development. Until recently, Americans had been consuming too much. A small or non-existent stock of savings left many people in debt and extremely vulnerable to economic hardship during the recession. Born-again Keynesian Richard Posner sees consumption as the engine of economic growth. Certainly growth in America in the last several years was supported by high levels of American consumption. But what about the future—will Americans continue to save more? If so, what does that mean for the American economy?
It is impossible to know the answer to the first question. The American personal saving rate already fell in 2009 from its 5.9% post-crisis peak in the third quarter, but it is still higher than pre-crisis levels. Though historically, before the later half of the 1990s, Americans saved much more. Perhaps the trauma of the financial crisis and the prospect of a retirement subsisting on cat food will change the American taste for saving. If credit remains scarce, and taking out multiple mortgages on your home is no longer an option, some Americans may be forced to consume less.

If Americans do save more that may bode well for long-term growth. The paradox of thrift, in many circumstances, is a short-run phenomenon. Americans have historically saved about 8% of their income and experienced economic growth. Over the long-term, a bigger stock of savings can increase growth. More savings lowers interest rates and provides more capital. That enables firms to undertake more capital investment, feeding growth and increasing income. In principle, if a country is saving too little, increasing the saving rate can generate enough new income so that it actually raises the level of consumption; even as people consume a smaller fraction of their wages.

Alas despite its low saving rate, America will probably not experience that effect. The American saving rate has certainly been too low, but the American economy was by no means under-capitalised. Capital from abroad has been feeding the American economy. If part of the new global financial order includes foreigners demanding fewer American assets, Americans must fund their own economic growth and start saving. Martin Feldstein argues that more domestic saving and less foreign investment will depreciate the dollar. But that is not all bad. For one thing it will make American exports more attractive, creating another source of demand. But this assumes the increase in private saving is not crowded out by a large increase in dis-saving from the government. The ever-growing debt and looming entitlement crisis suggest a bleak future for government saving. Between government spending and potentially less foreign investment, a higher private saving rate could be America's one saving grace in the new economy.

FINDINGS

"[Saving] is a paradox because in kindergarten we are all taught that thrift is always a good thing."—Paul A. Samuelson, first American to win the Nobel Prize in Economics (1970)

Normally, personal saving declines during recessions because people want to maintain their existing level of consumption. During the Great Recession, though, saving increased. The chart shows the personal saving rate, the year-over-year growth rate of gross domestic product, and recession periods from 2000 to 2011. Before the Great Recession, the average saving rate for the typical American household was 2.9 percent. Since the recession started in 2007, the average saving rate has risen to 5.0 percent. This increase was largely driven by uncertainty about future employment, efforts to reduce debt, and wide fluctuations in stock and housing prices. saving can have unintended consequences because one person's consumption is another person's income. During recessions, decreases in consumption could inhibit economic recovery. However, in the long run, the accumulated money from individual savers is available for capital investment, it is a situation where businesses borrow to purchase capital. Thus, an increase in the saving rate increases capital investment. Such increases in capital stock ultimately lead to higher levels of business productivity and growth. Because economists are largely concerned with long-run growth and economic theory notes the positive aspects of increased saving, the paradox of thrift remains a controversial concept. So ultimately, it is OK to save for that big purchase since future consumption benefits both you and society.

This increase in saving in America was largely driven by uncertainty about future employment, efforts to reduce debt, and wide fluctuations in stock and housing prices. Although this increase in saving benefits individuals who save more, some economists argue the dramatic change in saving behavior is detrimental to the overall economy. Given the benefits to individuals, how could saving harm the economy?

According to Keynesian theory, the proper response to an economic recession is more spending, more risk-taking and less savings. Keynesians believe a recessed economy does not produce at full capacity

because some of its factors of production — land, labor and capital — are unemployed.

LIMITATIONS

1. This theory was criticized by non-Keynesian economists on the ground that an increase in savings allows banks to lend more. This will make interest rates go down and lead to an increase in lending and, therefore, spending.
2. Few economists, such as Milton Friedman and Murray Rothbard, showed that the Keynesian model misrepresented the relationship between savings, investment and economic growth.
3.Neo classical economists say that savings represent loanable funds, particularly at banks, assuming the savings are held at banks. Thus an accumulation of savings yields an increase in potential lending, which will lower interest rates and stimulate borrowing.
4.If savings are held as cash, rather than being loaned out (directly or indirectly), then loanable funds do not increase, and thus a recession may be caused – but this is due to holding cash, not to saving
5.Banks themselves may hold cash, rather than loaning it out, which results in the growth of excess reserves – funds on deposit but not loaned out. This is argued to occur in liquidity trap situations
6.The paradox assumes a closed economy in which savings are not invested abroad. if one nation increases savings, this can be offset by trading partners consuming a greater amount relative to their own production, i.e., if the saving nation increases exports, and its partners increase imports. This criticism was accepted by Keynesians as well, who refer to it as "exporting one's way out of a recession".
7.The circular flow model ignores the lesson of Say's Law, which states goods must be produced before they can be exchanged. Capital machines, which drive higher levels of production, require additional savings and investment. The circular flow model only works in a framework without capital goods.
8.The theory ignores the effects of inflation or deflation. If higher current spending causes future prices to rise concordantly, future production and employment will remain unchanged. Similarly, if current thrift during a recession forces future prices to fall, future production and employment need not decline as Keynes predicted.

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