

PARADOX OF THRIFT

According to the classical economist the amount of saving is directly converted into investment. More the invested more will be the national income. So, the classical economist believed it is desirable for the economy to have higher saving rate.

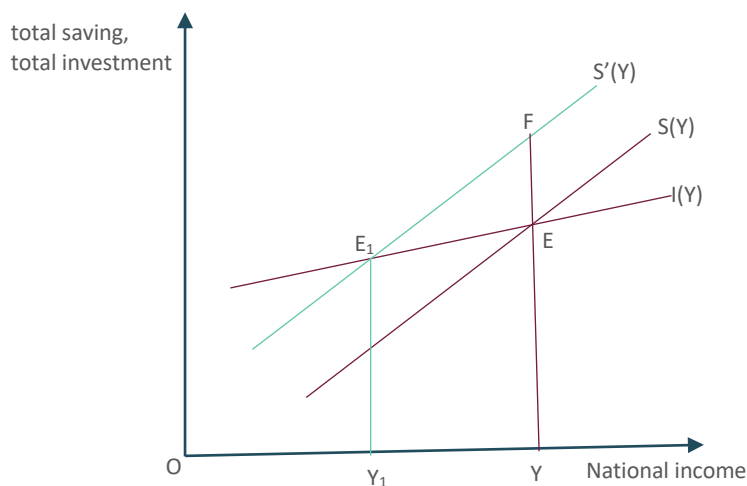
According to Keynes, it is desirable for individual to increase the amount of saving but not on an aggregate level. If everyone saves more simultaneously, then it will not lead to an increase in national income, in fact the equilibrium level of national income will decrease. This situation is known as paradox of thrift.

Suppose both investment and saving depend on income,

$$S = S(Y)$$

$$I = I(Y)$$

As the income increases so will the saving and the investment. Both the curve will be an upward sloping curve. Equilibrium will occur when $S = I$.



At equilibrium level is at E where the equilibrium national income is OY and the level of invest and saving is EY. If the aggregate level of saving increases as the marginal propensity to save increases then there will be an upward shift in the saving curve and it will move from $S(Y)$ to $S'(Y)$. Here the new equilibrium level will be E_1 and the new equilibrium national income will be OY_1 .

At the initial equilibrium level of national income OY, savings is equal to investment. When the savings increases, $S > I$ ($FY > EY$).

$$\begin{aligned} S &> I \\ \Rightarrow C + S &> C + I \\ \Rightarrow Y &> C + I \end{aligned}$$

Here aggregate supply is greater than the aggregate demand. As a result of it production will decrease and so will the level of national income. When the aggregate saving increases then that will lead to a decrease in the national income. This is known as paradox of thrift.