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The paradox of thrift

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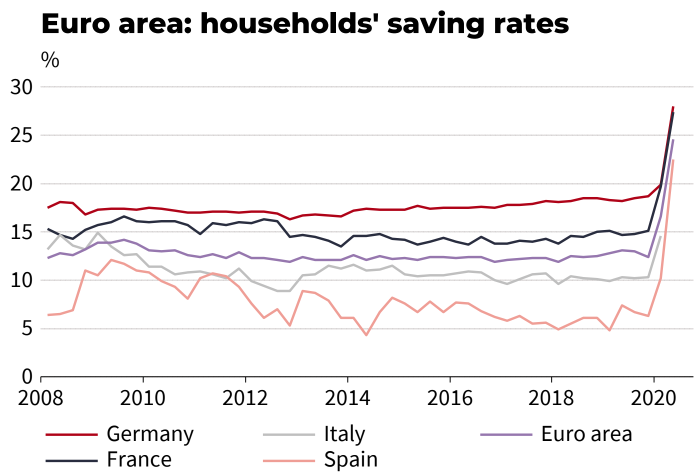
Uncertainty and pessimism have reached such heights that even workers whose jobs seem safe are reining in their spending and increasing their savings. But, as Keynes showed, while saving can be beneficial at an individual level, collectively it can have deleterious effects on the economy, as increased national savings reduces aggregate demand and worsens the recession that people are hoping to protect against. For Keynes, only the government can generate the demand that will lift the economy out of the equilibrium of under-employment caused by excess private savings.

In the 1930s, in the midst of the Great Depression, John Maynard Keynes regularly visited department stores in London to urge women to spend: "Buy new dresses if you want your husband to find work", he was hammering.



The paradox of thrift

Keynes feared that the economic crisis would push economic agents to hoard more. In times of crisis, it is quite natural for individuals to want to save more and therefore reduce their spending to protect themselves from tougher times ahead. The problem is that when this behaviour spreads throughout the entire population, it becomes detrimental to the economy as a whole, as it worsens the recession everyone is trying to protect against. Indeed, a contraction in consumer spending reduces the market for goods, harming companies' sales and therefore their profit outlook, leading them to lower their production and investment spending and cut jobs. The decline in business activity, rising unemployment and the resulting drop in revenues in turn exacerbate the overall pessimism and encourage even more precautionary savings, trapping the economy in a vicious cycle of recession.

Hence what Keynes called the "paradox of thrift": when everyone tries to increase saving simultaneously, then aggregate demand falls, which depresses the economy leading eventually to a flattening or diminishing of the total savings rate because of lower output.

It's up to the government to spend more

For Keynes, only the government can generate the demand that will pull the economy out of the recessionary dynamic caused by excess private savings. The government should increase its deficit, particularly through public spending—for example by investing in infrastructure and education—in order to absorb excess private savings and create a positive demand shock. The public deficit will generate additional output, proportionally by a factor of k (the fiscal multiplier). This increase in output will push up revenues, thereby boosting consumption and aggregate demand. With three limits, however, related to savings, imports and taxes (the additional revenue is never fully spent on goods produced in the country), which define the size of k.

The effectiveness of fiscal stimulus was soon called into question, first by "neoclassical" economists, then by "new classical" economists. In this regard, a turning point was the 1974 publication by Robert Barro formalising the Ricardian equivalence, according to which economic agents have rational expectations. As such, the public will expect the higher budget deficit to lead to future tax increases, and will therefore, to prepare for these eventualities, increase their savings, thereby counteracting the effect of the government stimulus[1].

Fiscal policy has now widely returned to centre stage

As Robert Lucas told a journalist from The Times on 28 October 2008, "I guess everyone is a Keynesian in the foxhole". In a remarkable move, in March 2020, the European Union suspended the Stability and Growth Pact and with it the fiscal discipline imposed on euro zone member states. Euro zone governments can now pump as much money into their economy as needed to ward off recession since they are no longer required to keep their public deficit within 3% of GDP and public debt below 60% of GDP.

In a liquidity trap (where excess savings coexist with central bank interest rates at zero)[2], **fiscal policy is most effective**. Since the 2008 financial crisis, several studies have sought to measure the impact of fiscal stimulus on activity when the nominal interest rate reaches its zero-lower bound. These studies show that in such circumstances, fiscal multipliers are high, well above one (i.e. GDP rises by more than the increase in public spending), partly because public investment does not crowd out private investment.

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[1] Robert J. Barro (1974), Are Government Bonds Net Wealth? *Journal of Political Economy*, November.

[2] See MH Duprat (2020), "The Global Liquidity Trap", *Economics For All*, Société Générale, February.

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