



## Paradox of Savings

**For Prelims:** Paradox of Savings, Paradox of Thrift, [Savings Rates](#), [John Maynard Keynes](#), [Microfinance](#), [Reserve Bank of India](#), [Sagarmala](#), [Bharatmala](#)

**For Mains:** Application of Paradox of Savings in Context of India

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### Why in News?

Recently, the **paradox of savings**, or the **paradox of thrift**, has been a topic of interest in economic discussions due to its implications on how personal savings behaviors might negatively affect broader **economic growth**.

- This counterintuitive economic concept has resurfaced in news and analyses, particularly in times of **economic downturns**, where the balance between saving and spending becomes crucial to policy debates on how best to **stimulate recovery** and sustain **economic stability**.

### What is the Concept of the Paradox of Savings?

- **About:**
  - The paradox of savings, also known as the paradox of thrift, suggests that while **individual savings** are ostensibly good, an increase in overall **savings rates** across an economy may lead to a decrease in total economic savings.
  - This theory contrasts with the intuitive belief that **higher personal savings** directly contribute to **increased economic savings**.
- **Origins and Development of the Theory:**
  - **Key Historical Insights:** The idea was notably popularised by **John Maynard Keynes** in his influential 1936 book, **The General Theory of Employment, Interest, and Money**.
  - **Keynesian Perspective:** **Keynesian economists** argue that an **increase in savings reduces consumer spending** on final goods and services, which in turn decreases overall savings and investment.
    - They contend that **consumer spending drives economic growth** and that **savings are channelized** into investments aimed at producing goods for consumer markets.
    - **Insufficient consumer spending** can lead to a reduction in these investments, thus **harming economic growth**.
  - **Governmental Role:**
    - Keynesians advocate for **active governmental intervention**, particularly in times of economic downturns.
      - Measures could include **increasing government spending** to boost consumer purchasing power and stimulate demand.
- **Counter Arguments:**
  - Critics of the paradox argue that **savings contribute to a pool of capital** that can be

used for investment, potentially **leading to economic growth** even in the context of reduced consumer spending.

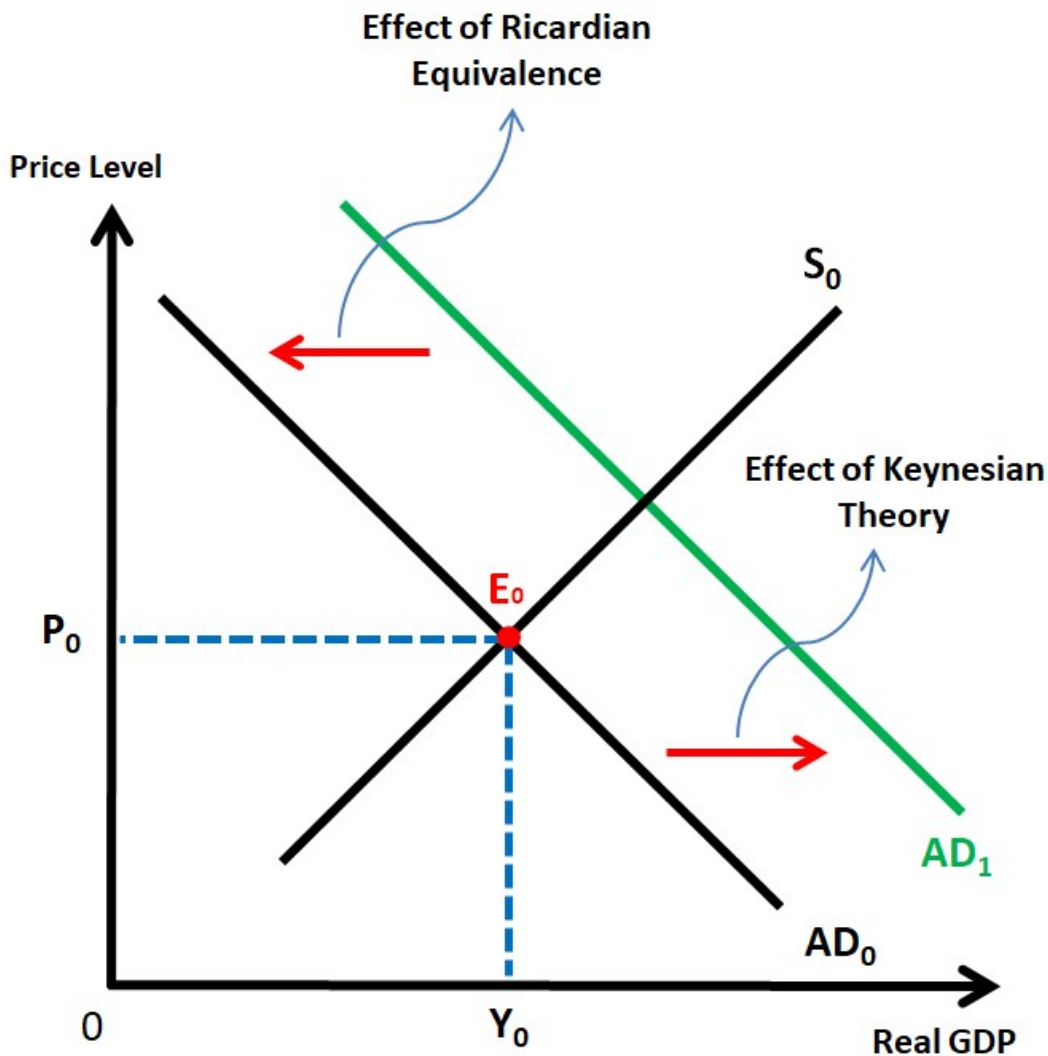
- A decrease in consumer demand **shifts investment from short-term**, consumer-driven production **to long-term projects**, potentially making previously unviable projects viable.

## How the Paradox of Thrift Plays Out in Indian Context?

- **The Indian Context:**
  - **Indian's high savings rate, beneficial for long-term security**, may hinder economic growth in slowdowns.
  - A sizable informal sector with limited savings complicates matters; policies promoting **formalisation can boost savings and enhance credit access**.
  - Low demand may deter businesses from investing in new projects, shrinking the overall investment pool, a critical concern for India's infrastructure and job creation needs.
- **Mitigating Factors:**
  - An **efficient banking system** can channel savings into productive investments.
  - During economic downturns, the **government can increase spending on** infrastructure and social programs, stimulating demand and creating jobs.
  - Principles from **behavioral economics** can be used to encourage consumption during economic downturns.

## How Does the Ricardian Equivalence Proposition Plays Out in India?

- **The Crowding-Out Effect:** The economic survey (2021) discusses the **crowding-out effect**, where increased government spending potentially reduces private investment by causing **higher interest rates**.
- This effect is linked to the **Ricardian Equivalence Proposition (REP)**, which assumes **perfect capital markets** and suggests that consumers save in anticipation of **future taxes**, thus neutralising government spending's impact.
  - However, the strict assumptions of REP may not hold true in **complex and developing economies** like India.
- **India's Economic Landscape:** Unlike the fixed savings supply assumed in the crowding-out theory, **India, as an emerging economy, sees an expanding savings** supply with income growth.
- Government spending can boost demand and employment, leading to increased savings and stimulating private investment.
- **Public expenditures** that support the **private sector's saving** and investment capacities can actually foster private investment, especially when directed towards infrastructure and development.
- **Economic Survey Insights:** The **Economic Survey of India (2020-21)** acknowledges potential **short-term crowding-out effects** but emphasises the long-term benefits where public investments stimulate private investments.
- It highlights the growth in **credit to the MSME sector** and increased capital expenditure by the government as vital economic growth drivers.
- The survey suggests that in India, **public spending complements private investment**, aiding the country's overall economic progress.



## Conclusion

- The paradox of savings presents a **significant theoretical challenge** to conventional economic wisdom that favours savings unequivocally.
- While **Keynesian economists** highlight **potential negative impacts** of increased savings rates on economic activity, **critics offer a different perspective** that sees savings as a flexible tool for adjusting economic production and investment across time, potentially **leading to more sustainable long-term growth**.

### Drishti Mains Questions:

Q. Discuss the relevance of the paradox of thrift in the context of the Indian economy. How does individual saving behaviour impact overall economic growth and aggregate demand?

## UPSC Civil Services Examination, Previous Year Question (PYQ)

### Prelims:

Q. In India, the interest rate on savings accounts in all the nationalized commercial banks is

**fixed by (2010)**

- (a) Union Ministry of Finance
- (b) Union Finance Commission
- (c) Indian Banks' Association
- (d) None of the above

**Ans: (d)**

**Q. If the interest rate is decreased in an economy, it will (2014)**

- (a) decrease the consumption expenditure in the economy
- (b) increase the tax collection of the Government
- (c) increase the investment expenditure in the economy
- (d) increase the total savings in the economy

**Ans: (c)**

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**Mains:**

**Q.** Among several factors for India's potential growth, savings rate is the most effective one. Do you agree? What are the other factors available for growth potential?

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