Paradox of thrift

The paradox of thrift highlights that attempts by households to save a greater proportion of their income may not actually lead to an increase in the overall level of savings.

Imagine a two sector economy with just households and firms. This means the only injection is investment and the only withdrawal is savings.

For equilibrium planned injections = planned withdrawals i.e. in a two sector economy:
Planned Investment = Planned Savings

The amount that households do not want to buy is purchased by firms who are investing.

If the proportion being saved increases, this results in less spending by households. Aggregate demand falls and will reduce the equilibrium output. Output and income will fall until equilibrium is reached where planned S = planned I again. Given that planned investment by firms has not changed this means the level of planned savings will be the same as it was originally as well. Households will be saving more of a lower income.

Example
Imagine planned saving is 0.5 of income (Y) and planned investment is 50
For equilibrium in a two sector economy (with no trade and government), planned saving equals planned investment
0.2Y = 50
Y = 250. Equilibrium national income is £250

If households decide to save 0.5 of their income
0.5Y = 50
Y = 100

Households start to save more which reduces demand and income until they end up saving a higher proportion (0.5 of income not 0.2) but the same absolute amount (£50).

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