

From Paul Krugman's *New York Times* blog, "Conscience of a Liberal"

August 26, 2010, 9:38 AM

We're Still In A Paradox Of Thrift World

This morning Bloomberg has a story about how business investment — which was one of the few sources of strength lately — is flagging. Why? Because of concerns about overall economic growth.

This should serve as a reminder that we're still very much in a paradox of thrift world.

In normal times, we believe that more saving, private or public, leads to more investment, because it frees up funds. But for that story to work, you have to have some channel through which higher savings increase the incentive to invest. And the way it works in practice, in good times, is that higher savings allow the Fed to cut interest rates, making capital cheaper, and hence on to investment.

But right now we're up against the zero lower bound — yes, I'll get the usual complaints about how long-term rates aren't zero, but the Fed doesn't have direct control over those rates — so this normal channel doesn't work.

And what that means is that if people — or the government — try to save more, they only end up depressing the economy. And the weaker economy leads to lower, not higher investment. And this in turn means that attempts to save more don't help our future prospects. On the contrary, they reduce the economy's future growth.

That's why fiscal austerity is such a terrible idea: not only does it raise unemployment, it actually makes us poorer in the long run.