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# Investment-Created Saving vs. The Paradox of Thrift: A Stock-Flow Consistent Model

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**Wenli Cheng**

**Abstract:**

This paper develops a Stock-Flow Consistent (SFC) model to analyze the macroeconomic effects of investment and saving decisions. The model explicitly represents the monetary circuit: money is created when the Bank issues loans to finance production; it circulates the economy through transactions between firms and households; and is destroyed when firms repay their loans with sales revenue. The stationary state is a monetary equilibrium in which the flow of credit, income, and expenditure is synchronized with the flow of inputs, goods and services. We examine three transitional experiments. First, in a capital expansion scenario, we show that when a firm invests, real resources are redirected from consumption to capital formation, compelling households to reduce consumption and accumulate capital wealth. This is real saving. At the same time, the expenditure on capital goods generates new income that cannot be spent on consumption goods (priced at cost) and must therefore be saved. This is monetary saving. Investment thus creates both the real and monetary saving needed to finance it. Second, we investigate two variants of the Paradox of Thrift. In the first, the firm maintains its capital stock in anticipation of recovery, and the contraction proves temporary. In the second, the firm reduces its capital stock, leading to a permanent decline in output and household incomes. The results suggest a fundamental asymmetry: investment creates the saving needed to finance it, whereas households saving does not automatically convert to investment. In the absence of corresponding investment, saving can lead to reduced output and income. The findings also highlight the critical role of firm expectations in determining the long- run consequences of saving shocks.

**Keywords:** Stock-Flow Consistent Models, Monetary Circuit, Investment-Created Savings, Paradox of Thrift, Business Cycles, Transitional Dynamic

**JEL Classification:** E12, E21, E22, E25, E32

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