

Saving and Investing

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The term "Saving" and "investing" are sometimes used interchangeably. However, in economic terms, saving and investing are two separate things. Broadly speaking, individuals have two choices when it comes to the income they receive after taxes. They can either spend it on current consumption or they can save for the future. People save money when they put their unspent income into banks or other financial institutions, or buy stocks, bonds, or mutual funds. This kind of saving is sometimes called financial investment, and is crucial to building personal wealth.

There are many reasons why people choose to save. They may want to make a large purchase such as a new car, or boat, or perhaps they want to be secure in case of an emergency, or maybe they want to save for their children's education, or for their retirement. No matter what their reasons, people's decisions about personal savings have an effect on the economy as a whole. The decision to save makes more money available as loanable funds. Without the availability of this money, it would be difficult for those who want to invest in growth-producing capital to do so.

In economics, the term "investing" is used to describe the purchase of capital for the production of goods and services. When firms decide to purchase equipment, factories, and other resources, they are engaging in what is called "real investment". The amount of real investment is critical to economic growth. Both saving and investing are connected. Producers often borrow from the loanable funds market which consists of savings. This borrowed money is invested in resources that produce goods and services. When considering whether to save money, people weigh the costs and benefits of saving. Saving money means forgoing the benefit of consuming today in order to grow their money and potentially consume more tomorrow. The decision to spend money now means giving up the opportunity to spend possibly more due to growth in the future.

Another factor when deciding to save money is the amount that your savings can grow. Individuals need to consider not only the interest rate that they can earn on their savings, but also the current and projected rate of inflation. If the rate of inflation outpaces the rate of interest growth of your savings over a period of time, your savings can actually lose value. To describe the combined effect of interest growth and inflation, economists calculate the real interest rate. The real interest rate is the interest rate minus the rate of inflation. It helps you see how much your savings will actually be worth in the future. When savings grow in real value over time, it pays to save. When savings do not grow or grow very little, the cost of savings is high, relative to the benefits.