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WHAT IS CAPITAL? 5/99

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Q: What is capital?

A: In general terms, capital is an accumulation of items of value.

Q: As simple as that? Capital: an accumulation of value.

A: Yes. For example, if you save part of your earnings, the accumulated total is capital.

Q: I thought that capital is associated with investment rather than saving.

A: Indeed, it would be, if you chose to put your saving to work so as to yield earnings (for example, in the form of interest or dividends). In this situation, it would be more apt to describe yourself as having an investment portfolio of wealth assets: bonds, shares, *etc.*

Q: So capital is an accumulation of investments?

A: Yes.

Q: If it is *both* an accumulation of saving *and* an accumulation of investment, doesn't that make saving and investment the same? I thought they were different.

A: As you bear witness, saving and investment can give rise to some confusion.

Q: Then, please provide some clarification.

A: Conceptually, saving and investment *are* different. Saving is a negative act (a decision to 'wait-and-see') and investment is a positive act (involving some commitment with its associated uncertainty).

Q: Well that's clear enough. I can understand that distinction. So where does the confusion arise?

A: Although the concepts are clear, saving and investment must take some specific form.

Q: What do you mean?

A: In practice, you receive your income as bank credit or currency or even (in a barter economy) in the form of some commodity. If you then do nothing, your income is saved. As saving, your unspent income remains in the same form in which it was received.

Q: My income is paid directly into my bank account and, unless it is spent, that is the amount of my saving. So my saving is my capital which I hold in my bank account.

A: Where it may earn interest.

Q: In which case, my saving looks very much like an investment.

A: It certainly does. Your bank pays you interest in return for the use which it makes of your saving.

Q: What kind of use?

A: Well, for example, it might advance a loan (facilitated by your saving) to another of its clients, and charge interest at a higher rate than it pays you. The client benefits, the bank benefits and you benefit.

Q: How can we all be better off?

A: By the fact that the borrower uses his bank loan to finance some profitable investment.

Q: Let me see if I have grasped all of this. Saving is income which is not yet spent, but it is only 'saving' until such time as it is invested to earn a yield or interest.

A: That's fine; but you must remember that saving has some specific form which may look very much like an investment.

Q: Confusion again. Let's go back. You said that saving is a negative act, whereas investment is positive and involves commitment and uncertainty. Explain the uncertainty.

A: I said that it is the essence of an investment that some firm commitment is made. I also said that any commitment carries some degree of uncertainty. This means that the value of an investment can fluctuate unpredictably.

Q: Even in my bank account?

A: Of course. You must remember that all values are relative. If your unspent income (I conveniently avoid calling it 'saving' or 'investment') is committed to your bank account (or even currency), then its value will fluctuate in relation to the value it might have acquired in some other form.

Q: Even currency?

A: Of course. As, say, equity prices vary, the value of currency must vary (in relation to equity values). Across any period of time, your investment in currency (relative to your investment in equities) might show either a positive or a negative yield.

Q: So, saving is purely a concept: it is income which is not spent. However, because saving is necessarily committed to some specific form, it necessarily takes on the characteristic of an investment?

A: I couldn't have expressed it more clearly. Well done!

Q: Thank you. Now let's leave saving and investment. My question was 'what is capital?'

A: Saving is that part of income which is not spent. If it remains unspent it remains committed to some specific form: an investment. The accumulation of past investments is capital.

Q: You implied that investment comprises various kinds of financial securities: currency, bank accounts, investment trusts, bonds, equities, and so on. Yet, investment can be in the form of buildings, machinery, vehicles ...

A: ... but of course. There is virtually nothing which cannot be regarded as an investment. If it is durable and has been acquired with a view to obtaining a yield, it is an investment. Such investments that you have categorised as 'financial' may have a physical counter-part.

Q: Which?

A: Equity. When first sold, shares in many public companies are the means by which buildings and machinery can be acquired.

Q: And my dividends represent the yield from those investments?

A: More than likely they represent a part. Another part may have been re-invested in the company, in which case you may receive an additional return in the form of capital appreciation.

Q: The value of the company rises.

A: Precisely; successful re-investments cause the market value of your equity holding to increase.

Q: Capital appreciation.

A: No doubt, very much appreciated!

Q: Can we stop there?

A: That would be premature.

Q: How so?

A: Well there is another approach we might try to grasp the nature of capital and investment. Consider Robinson Crusoe ...

Q: ... alone on his island

A: ... using just his bare hands to catch fish.

Q: His entire 'income' is fish ...

A: ... but he could increase his income if he had a net or a boat.

Q: So he makes a net and he builds a boat.

A: Not so fast. What is he to eat while he is investing his labour in the production of those capital assets?

Q: He would have to had to 'save' some of his hand-caught fish until he had sufficient (presumably sun-dried) to eat during the time it takes to make a net and to build a boat.

A: Bravo! Saving (fish) supports Crusoe's investment (of his labour) in the production of capital (nets and boat)

Q: That's brilliant!

A: You are too kind.

Q: So, can we stop there?

A: Perhaps we should.