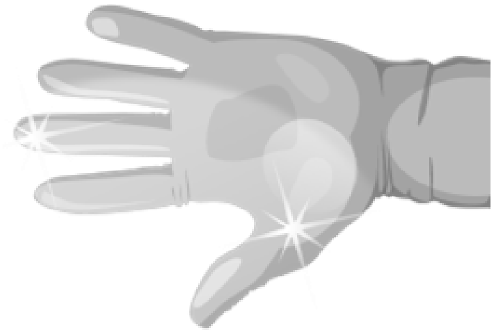
Saving, Investing, and The Invisible Hand



In a market economy, most basic economic questions about how to use resources are answered by millions of individuals in households and businesses. They decide what goods and services will be produced, how they will be produced, and who will consume the goods and services that are produced.

A key assumption in market economies is that households and business owners usually have better information for making saving and investment decisions that promote their own objectives and take into account their own circumstances than government planners do. After all, how could a relatively small number of government officials have sufficient information to make sound saving and investment decisions regarding thousands of firms and millions of households? Individual savers and investors also have stronger incentives to make good and careful decisions, because they hope to enjoy financial gains as a result of their decisions, and avoid losses.

In countries with market economies, banks provide essential financial services for individual households and businesses, and in the process facilitate economic growth for the overall economy. First, banks provide a safe place for individuals to keep their checking and savings accounts. Banks then lend out a large part of those deposits, to help some people start and expand businesses, and many other individuals purchase homes and expensive durable goods, such as refrigerators and cars. Other people borrow money to purchase expensive services, such as education for their children, or medical care, or a foreign vacation.

In developed market economies, financial markets such as stock markets and bond markets also play a critical role in promoting good investment and business practices. Millions of investors – usually working through brokerage firms that analyze thousands of large companies' past performance and plans for future operations and investments – compete to invest in the firms that will earn the highest profits at a reasonable level of risk. Over the long run, firms that are successful will experience rising stock prices. Firms that are unsuccessful or not managed as well as they could be will experience falling stock prices, and eventually go out of business or be taken over by other companies and managers.

Questions for Discussion

1. Who makes most decisions about *how much* to save and invest in a market economy, and about *how* to save and invest?

2. When savers in households decide to use some of their savings to buy stocks, how are they acting in their own self-interest?

3. When business owners decide to borrow money or issue shares of stock, how are they acting in their self-interest?

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4. Why are individuals in households and businesses more likely to make saving and investment decisions that advance their own economic interests more effectively than decisions made by government officials?

5. Last year we discussed Adam Smith's concept of the invisible hand:

   "Every individual … neither intends to promote the public interest, nor knows how much he is promoting it … He intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was not part of his intention. Nor is it always the worse for the society that it has no part in it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it."

   How does this article about saving and investing relate to Adam Smith's concept of the invisible hand?

6. Why are banks and financial markets important to economic growth? What role do they serve?