**Meaning of Capital Formation:**

Capital formation means increasing the stock of real capital in a country.

In other words, capital formation involves making of more capital goods such as machines, tools, factories, transport equipment, materials, electricity, etc., which are all used for future production of goods.

For making additions to the stock of Capital, saving and investment are essential.

#### Three Stages in Capital Formation:

Although saving is essential for capital formation, but in a monetized economy, saving may not directly and automatically result in the production of capital goods. Savings must be invested in order to have capital goods. In a modern economy, where saving and investment are done mainly by two different classes of people, there must be certain means or mechanism whereby the savings of the people are obtained and mobilized in order to give them to the businessmen or entrepreneurs to invest in capital.

**Therefore, in a modern free enterprise economy, the process of capital formation consists of the following three stages:**

**(a) Creation of Savings:**

An increase in the volume of real savings so that resources, that would have been devoted to the production of consumption goods, should be released for purposes of capital formation.

**(b) Mobilization of Savings:**

A finance and credit mechanism, so that the available resources are obtained by private investors or government for capital formation.

**(c) Investment of Savings:**

The act of investment itself so that resources are actually used for the production of capital goods.

#### Foreign Capital:

Capital formation in a country can also take place with the help of foreign capital, i.e., foreign savings.

**Foreign capital can take the form of:**

(a) Direct private investment by foreigners,

(b) Loans or grants by foreign governments,

(c) Loans by international agencies like the World Bank.