11|04|2020 Degree-II (Eco. Hons.)

Investment Function

In this section of macro economic analysis, we should know the factors that determine investment function. Investment is the most volatile of the major components of aggregate demand and output because of the operation of the multiplier mechanism.

An investment demand function indicates the values of output demanded for investment purposes of each possible rate of interest. Most of the components of investment demand are demands by business for output with which to maintain or increase stocks of capital goods, these demands are presumably motivated by a desire of profits perhaps a desire to maximise their profits. For this purpose they compare the expected returns from new investments.

Marginal Efficiency of Investment (MEI)

The level of investment spending is made by business firms

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extent of making net profits. Hence, in determining whether or not to make a capital expenditure, they are interested in net revenues over costs. This applies to purchases for replacement as well as to net additions to capital. Decisions as to the amount of new investment therefore depend on a comparison of interest costs and the expected annual rate of return on new investment. The later has given many names, including marginal revenue product of capital and marginal efficiency of investment. We can use the latter term and define it as the annual amount that the acquisitions of the new capital goods is expected to add to the enterprise's net revenues after deduction of all additional costs of operation except interest costs on the money used. We can view the marginal efficiency of investment as a schedule or function showing the various amounts of new investments that are expected to yield at least various rates of return. The demand for investment is derived from the marginal efficiency of investment schedule. Entrepreneurs intent on maximising their profits tend to buy those types and amounts of capital that they expect to yield a rate of return in excess of the interest cost of the money used to purchase them. Presumably, they will not buy capital whose expected rate of return is below the interest rate.

In above analysis we have emphasised that the expected annual rates of return is a prime consideration in the selection of a new investment. Entrepreneurs select their investments on the basis of their expectations as to future yields. Their decisions are based on the best forecasts they can make. They

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cannot be certain that the returns will meet their expectations because many types of capital yield returns only over a long period and much can change in the interim. Even then, they must act and take decisions.

Factors affect the Schedule of Marginal Efficiency of Investment (MEI) :-

Following are the important factors which affect the MEI :-

(I) Size and composition of stock of capital goods.

(II) Rate of Innovations.

(III) Expected future behaviour of demand for output.

(IV) Expectations and Business confidence.

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