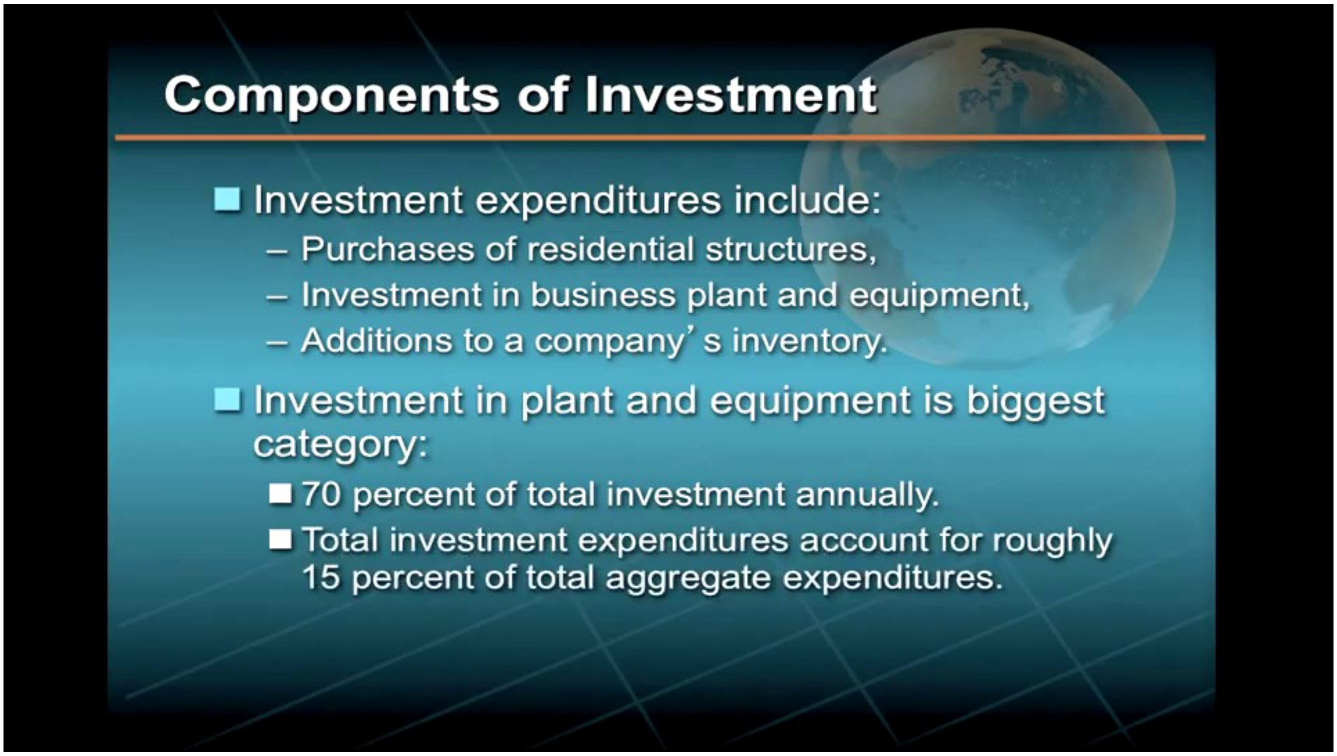
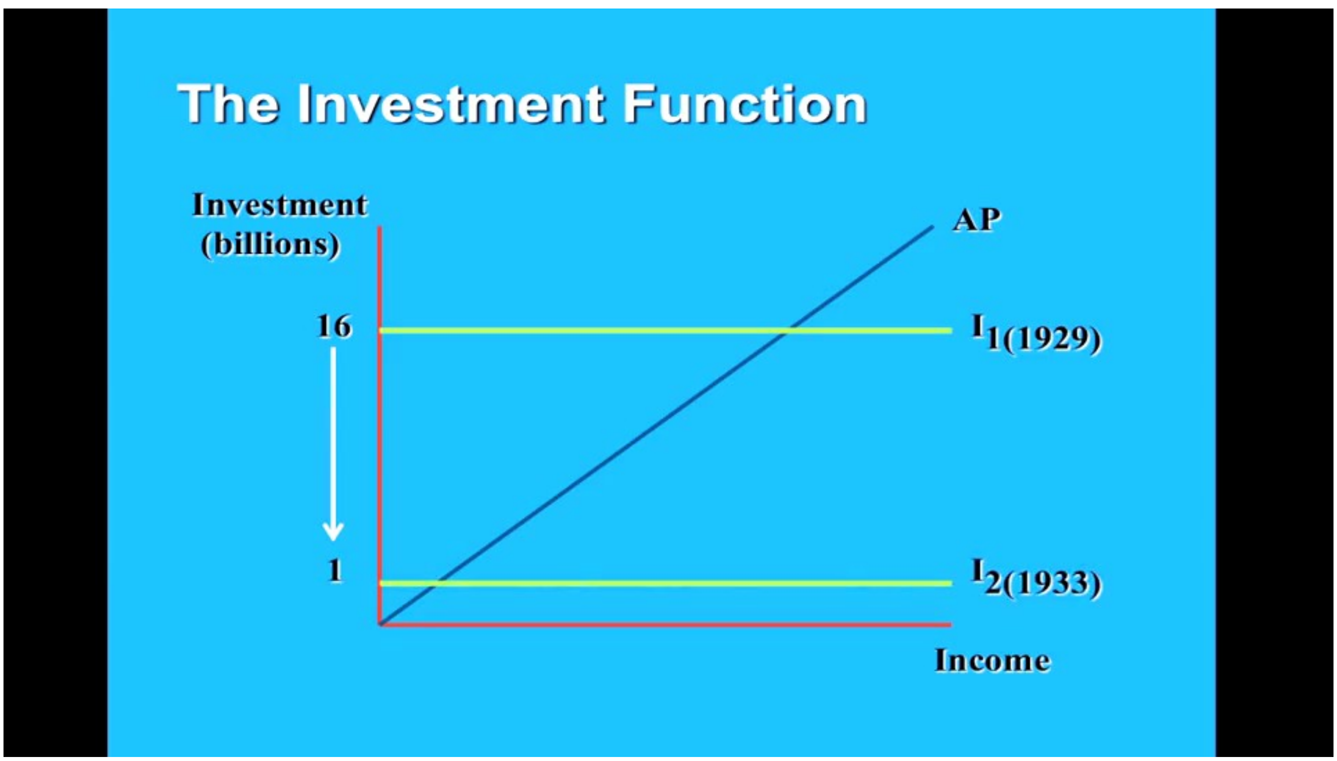

LECTURE THREE - PART THREE


THE KEYNESIAN INVESTMENT
FUNCTION


Components of Investment
Investment expenditures include:
– Purchases of residential structures,
– Investment in business plant and equipment,
– Additions to a company's inventory.
Investment in plant and equipment is biggest category:
70 percent of total investment annually.
Total investment expenditures account for roughly 15 percent of total aggregate expenditures.


The Investment Function
Investment (billions)
AP
16
I1(1929)
1
I2(1933)
Income

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Determinants of Investment?

- Keynes believed investment was sensitive to changes in the interest rate.

Interest rates ↓ Investment ↑

Interest rates ↑ Investment ↓

Keynes vs. the Classicals Redux

- Keynes did <u>not</u> believe that falling interest rates and increased investment would necessarily lead to a full employment equilibrium like the Classical economists did.

Keynes's Animal Spirits

- Investment is driven by "animal spirits."
  - These are the "expectations" businesses have regarding potential sales and profits.
- If businesses believe the economy will go bad, it could become a self-fulfilling prophecy.
  - Businesses with a bearish view of the economy would cut back on investment and production and help trigger a recessionary spiral.

THE GOVERNMENT EXPENDITURE FUNCTION

Government Expenditures

- Government purchases of equipment like tanks and road-building equipment.
- Payment for services of judges and public school teachers.
- The government expenditure function is determined directly by the government's own decisions.
- For example, the Pentagon's purchase of a new jet fighter adds directly to the gross domestic product or GDP.

The Government Expenditure Function

- Government expenditures account for almost 20% of total aggregate expenditures.
- The Keynesian model assumes G to be autonomous, i.e., determined outside the model.
  - Thus, G equals autonomous government expenditures G_0.
- As with the investment function, the government expenditure function can be graphically portrayed as a horizontal line.

Volatility of Government Expenditures

- Government expenditures are less volatile than investment.
- Episodic events such as wars and natural disasters can lead to large fluctuations in G.

Keynesian Fiscal Policy

- In the Keynesian model, increased or decreased government expenditures, together with tax cuts or tax increases, serve as the primary tools of fiscal policy that are used to counterbalance changes in investment and consumption spending.

Applied Fiscal Policy

- Expansionary fiscal policy:
  - Increase G and/or cut T to close a recessionary gap.
- Contractionary fiscal policy:
  - Cut G and/or raise T to cool down an overheated economy and curb inflation.

Transfer Payments are Automatic Stabilizers

- "Transfer payments" include unemployment compensation, welfare payments, and subsidies.
- Transfer payments are "automatic stabilizers:
  - They help stabilize the economy because they automatically rise during recessions and fall during expansions.
- For example, during recessions, as more people become unemployed, they become eligible for these programs.
- In contrast, as the economy expands, there is less need for welfare payments.

THE NET EXPORTS FUNCTION

What We Export

- "Net Exports" represent the difference between the exports we sell to the world and the foreign imports we buy.
- U.S. exports range from the sale of aircraft to China and beef and oranges to Europe and medical equipment to Canada.

What We Import

Exports Add to GDP, Imports Subtract

- Exports create domestic production, income, & employment for an economy.
  - Exports <u>add</u> to aggregate expenditures.
- Buying imports means no production, income, or employment is created.
  - Imports <u>subtract</u> from aggregate expenditures.

Net Exports Assumed Away in Simple Keynesian Model

- Net exports are a critical part of an "open" economy, but they were not central to the development of the Keynesian model.
- The simplified Keynesian model assumes a "closed economy" in which there is no international trade!!!
- This assumption allows us to focus solely on the role of government spending in fiscal policy.