CONSUMPTION, INVESTMENT AND NET EXPORTS

DISCUSSION CONTENTS

Investment

The Investment Demand Curve

Exports

INVESTMENT

- In the national income accounts, investment consists of residential construction, non-residential construction, producers' durable equipment, and changes in business inventories.
- Generally speaking, the decision to invest is a negative function of the rate of interest, holding all other factors (**non-interest variables**) constant.
- It is the least stable component of aggregate spending and a principal cause of the business cycle in the national income accounts.

REAL GDP AND REAL INVESTMENT , USA 1970-1992

- Fig presents the annual percentage change in real GDP, real gross investment and the peaks and troughs in economic activity in the US between 1970 and 1993
- Both real GDP and real investment display a cyclical movement.
- It rose after a business cycle trough and fell after a business cycle peak

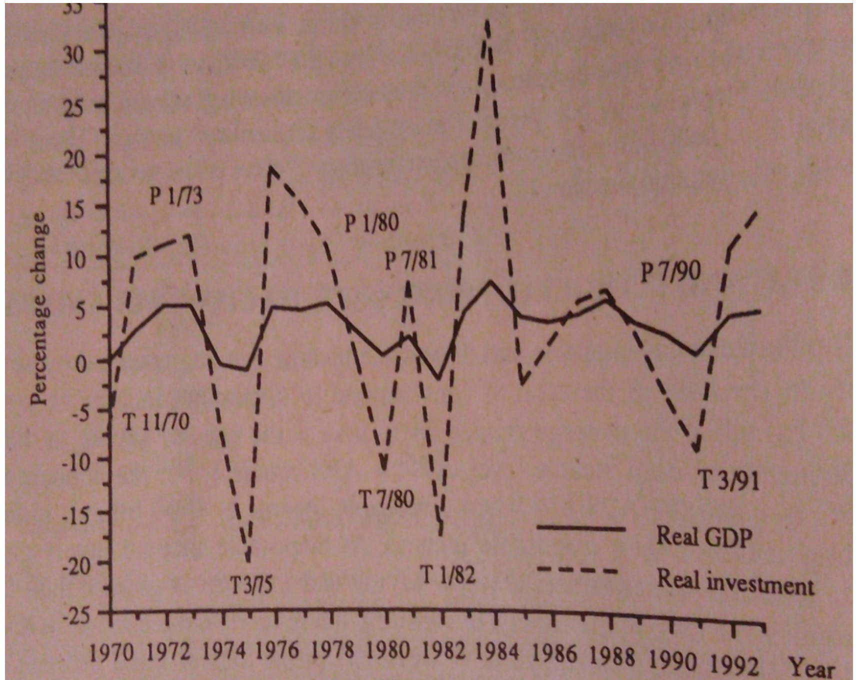

Fig. 6-3

- Investment spending displays larger and more dramatic changes
- **Because of this, investment is considered the principal cause of economic fluctuations**

Business cycles

- Monetary policy seeks to:
- dampen economic fluctuations by moderating the growth of investment spending during an economic expansion
- and slowing the decline in investment during a recession

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INVESTMENT (cont'd.)

Other non-interest variables affecting investment demand include:

(a) residential construction i.e. purchase of housing units (single family and multi-family units)

. Residential construction depends upon the willingness and ability of individuals to purchase housing units

This is also influenced by:

- demographics (size of house buying population)
- buyer's level of indebtedness
- wealth of buyers
- current and expected income level
- willingness to incur new debt
- ability of buyers to obtain loan
- cost of housing units, and
- mortgage rate of interest.

INVESTMENT (cont'd.)

(b) non-residential construction i.e. offices, hotels and other commercial real estate.

Their demand is also influenced by:

- **the rate of interest**
- **the vacancy rate of existing units**
- **needs for additional commercial space**
- **ability of business units to meet increased rental costs**

INVESTMENT (cont'd.)

(c) producers' durable equipment (equipment purchases by businesses) is influenced by:

- borrowing costs
- utilization of existing productive capacity
- availability of more efficient technology
- current and expected sales
- existing and future competition

(d) changes in business inventories are linked to:

- rate of interest
- current and expected sales
- current and expected inventory prices
- certainty of inventory deliveries

THE INVESTMENT DEMAND CURVE

It is a curve that shows the relationship between gross investment and the rate of interest, while other variables affecting investment spending are held constant.

Investment spending is inversely related to the rate of interest i.e. the higher the investment the lower the rate of interest and vice -versa.

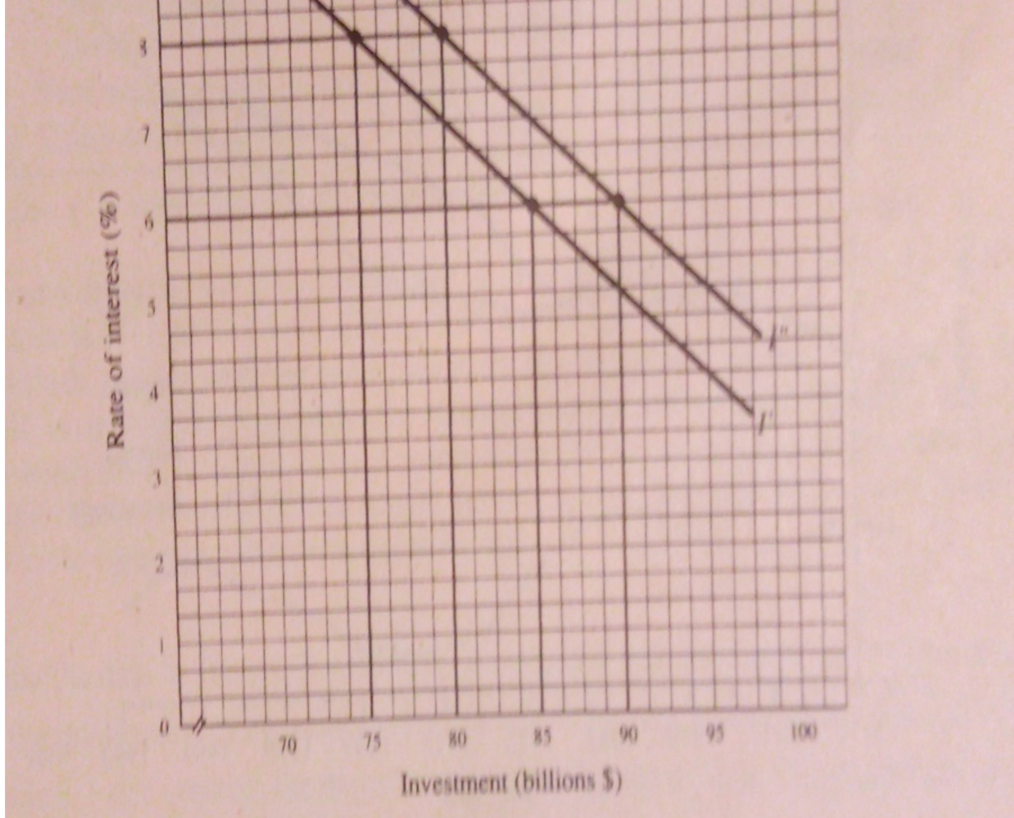

Fig. 6-4

NT DEMAND CURVE

- An investment demand curve shows the relationship between:
- gross investment and
- the rate of interest, holding constant other variables that affect investment spending

- Investment spending is inversely related to the rate of interest, meaning
- A lower rate of interest is associated with a higher level of investment,
- In another word, a higher rate of interest is associated with a lower level of investment, holding other variables constant

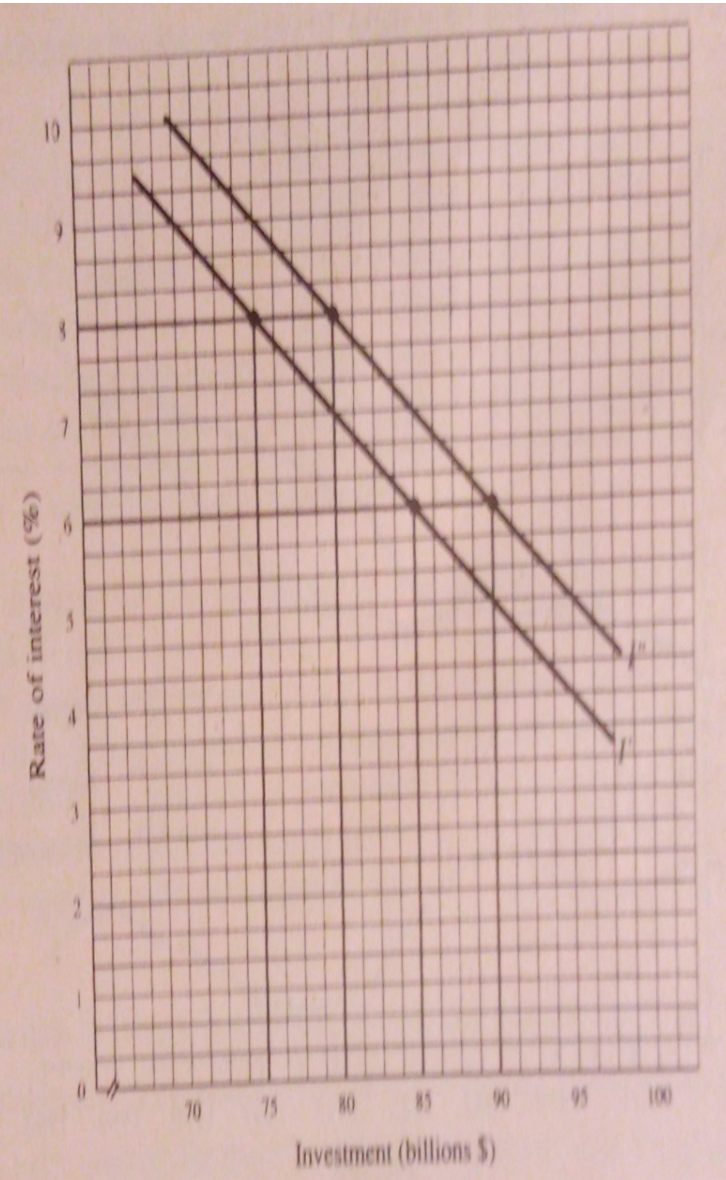

Fig. 6-4

GROSS EXPORTS AND GROSS IMPORTS

Gross exports are the value of goods and services produced in a home country and sold abroad.

Gross imports are the value of goods and services purchased by a home country from abroad.

Imports usually lowers the aggregate spending of a nation on domestically produced goods.

Net exports are the value of gross exports less gross imports.

Net exports might be negative or positive. It is positive when the country exports more than it imports and negative when it imports more than it exports.

USA, IMPORTS, EXPORTS AND NET EXPORTS: 1975-1993

- Figure presents US gross exports, gross imports and net exports in 1987 dollars from 1975 to1993
- Note the substantial growth of gross exports and gross imports and net exports in the 1980s
- Also note that US had a negative net export balance in 14 out of 19 years
- This means that aggregate spending on US produced goods and services was lower in 14 of these 19 years because of negative net export balance

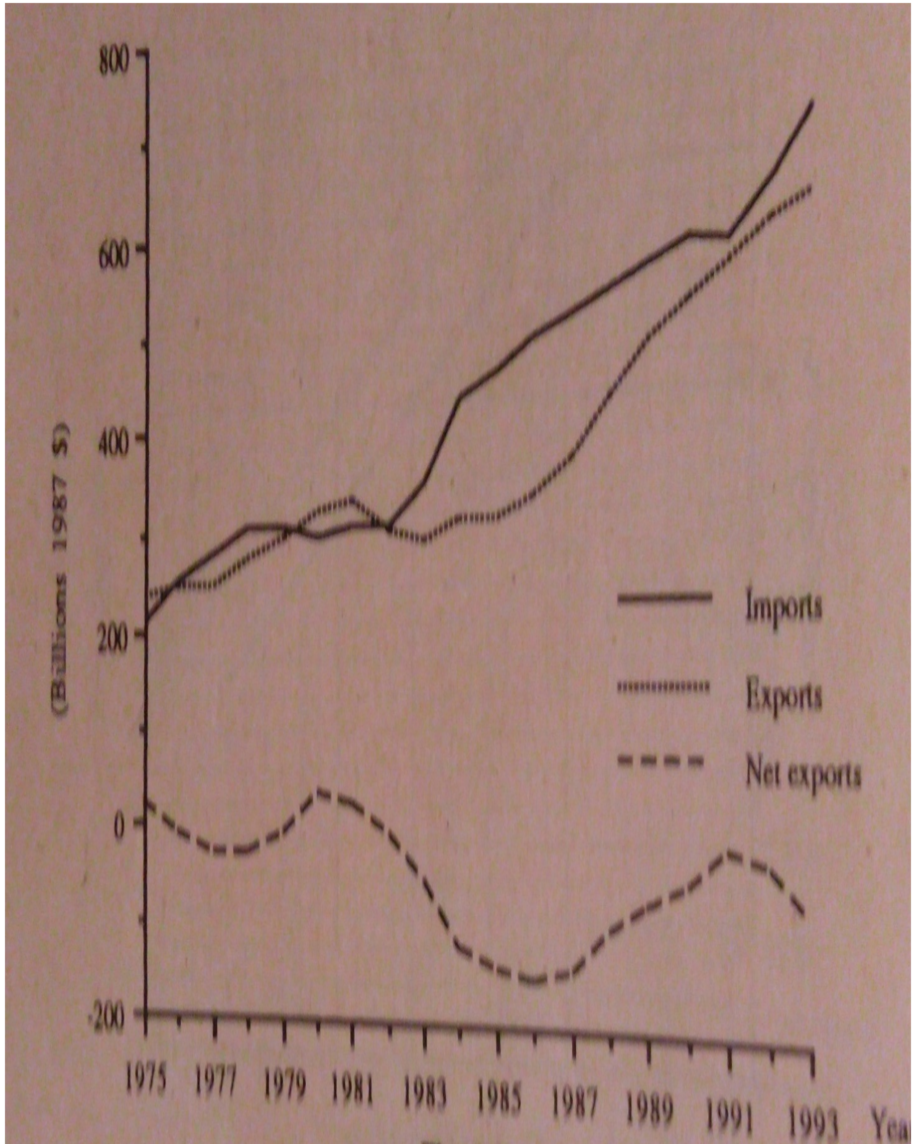

Fig. 6-5

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NET-EXPORTS

- Net exports are the value of gross exports less gross imports
- It is the net addition to domestic aggregate spending that results from importing and exporting goods and services
- Net exports are positive when the home country exports more than it imports
- Net export is negative when the home country imports more than it exports.

FACTORS AFFECTING IMPORTS AND EXPORTS

- Level of income
- Foreign exchange rate
- Domestic price relative to prices in foreign countries
- Import tariffs
- Restrictions on imported goods

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