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Macro Economics

(Investment Function)

Investment is determined by the level of interest rate and the marginal efficiency of capital.

$$I = f (r, MEC) \quad 1)$$

Here,

I = Investment, r = interest rate, MEC = Marginal Efficiency of Capital

Classical Economists were of the opinion that Investment depends on the rate of interest

Types of Investment

1. Fixed and Variable Investment
2. Real and Financial Investment
3. Gross and Net Investment
4. Autonomous and Induced Investment

To make an investment either own fund or borrowed fund or both the sources are utilised by the investors.

Investment Function Contd...

MEC (Marginal Efficiency of Capital)

- Represents profitability from the investment.
- Expected net returns from the investment in its life time (expected profit) and the cost of capital decides the MEC.
- Expected profit rate must always be more than rate of interest to make investment attractive and encourage investors to make new investment.
- Investor equilibrium (desired level of investment) is achieved where cost of capital equals expected profit from the capital after investment.
- Keynes has given more importance to expected profit margin than interest rate supposed to be paid on capital.
- Expectation always important role in the economy.
- MEC reduces as cost of investment increases but it rises with increase in the expected net returns from the investment

$$\text{MEC} = f(R, r)$$

2)

Here,

R = Expected net returns from the investment

r = cost of investment

Investment Function Contd...

Rate of Interest/ Cost of Capital (r)

- Inverse relationship between interest rate and the investment.
- Positive relationship between national income and the rate of investment.

Investment, according to Keynesian economics, is nothing less than the real investment in the forms of new factory buildings, roads and such physical infrastructure which directly generates new jobs and production capacities.

Question to be Studied

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Q. 1. Write a note on investment function

THANKS