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Macro Economics

Topic . Investment Multiplier Part I

- The Investment multiplier expresses the causal relationship between the change in investment and the change in consumption.
- It affects the national income.
- R. F. Kahn, British Economists, gave an employment multiplier in 1931. This multiplier explained the effect of an increase in the investment on the employment.
- J. M. Keynes used this concept to explain the effect of an increase in the investment on income. His theory is known as Investment Multiplier or Investment Income Multiplier.

Assumptions of the Multiplier Theory

1. MPC is constant
2. No changes in the monetary and fiscal policies, thereby leading to no effect on MPC
3. No lag between two subsequent periods. In other words, instant transition of the effects from change in the investment to the change in the income level of an economy.
4. Under employment of the factors of production is the characteristic of the economy
5. International economic transaction is absent in this economy. It is a closed economy.
6. Net investment is rising
7. Consumption is the function of the current income level

Topic . Investment Multiplier Part I Contd…

8 An autonomous investment is changing but induced investment is absent.

9 Consumer goods are available in response to effective demand.

10 Newly introduced investment level is maintained to realise the effects of multiplier

11 Consumer goods industry has excess capacity to meet the new demand.

12 Resources required for the production purposes are easily available.

13 A country is having industrial base

14 No change in the Price level

Investment Multiplier by J. M. Keynes

The multiplier, according to Keynes, "establishes a precise relationship, given the propensity to consume, between aggregate employment and income and the rate of investment. It tells us that, when there is an increment of investment, income will increase by an amount which is (K) times the increment of investment"

K=ΔY／ ΔI **1)**

Here,

K = multiplier coefficient which shows the power by which any initial investment expenditure is multiplied to obtain a ‘final change in income.

Topic . Investment Multiplier Part I Contd…

ΔY = small change in the NI

Δ I = small change in the Investment

- Value of **K** depends on the **MPC**
- Higher MPC, Higher K and vice-versa

So,

$K = \frac{1}{1-MPC}$ 2)

Or

$K = \frac{1}{MPS}$ 3)

- **0 < MPC < 1 and 1 < K < ∞**

1. If MPC = 0, K = 1 (implies MPS = 1)
2. If MPC = 1, K = **∞** (implies MPS = 0)

Both these situations are unstable and leading to either under employment and/or spiralling inflation in the economy.

So, the value of MPC lies between zero and one only.

- K is directly related with MPC and inversely related with MPS

- **Question to be Studied**

Q. 1. Discuss the investment multiplier with its assumptions.

THANKS