

Yogoda Satsanga Mahavidyalaya

B.COM Sem III

Subject: Macroeconomics

Topic: Unit 5: Meaning and Types of Investment

Meaning of Investment

The concept of economic investment means ***addition to the capital stock of the society***. The capital stock of the society is the goods which are used in the production of other goods. The term investment implies the formation of new and productive capital in the form of new construction and producers durable instrument such as plant and machinery. Inventories and human capital are also included in this concept. Thus, an investment, in economic terms, means an increase in building, equipment, and inventory.

Types of investment

1. **Business Fixed Investment:**

- Business fixed investment means ***investment in the machines, tools and equipment that businessmen buy for use in further production of goods and services.***
- The stock of these machines or plant equipment etc. ***represents fixed capital.***
- The term 'fixed' in it implies that expenditure made on the machines, equipment etc. ***continues to be used for production for a relatively long time.*** (This is in contrast to inventory investment whose components will be either used shortly for production or sold shortly to others for further production.)
- ***Business fixed investment is an important component of aggregate demand*** and therefore plays a significant role in the determination of national income and employment.

- **Business fixed investment is a volatile component of aggregate demand** and, as Keynes emphasized, **fluctuation in levels of fixed business investment is responsible for business cycles in a free market economy.**
- Keynes put forward a theory of investment which states that business fixed investment is determined by expected rate of profit (which he calls marginal efficiency of capital) and rate of interest. **Since rate of interest in the short run is relatively sticky, it is changes in expectations about earning profits in future that cause fluctuations in business fixed investment.**

2. Residential Investment:

- Residential investment refers to the **expenditure which people make on constructing or buying new houses or dwelling apartments for the purpose of living or renting out to others.**
- Residential investment varies from **3 per cent to 5 per cent of GDP** in various countries.
- Two important features of residential investment are worth noting. First, since the average life of a housing unit is of 40 to 50 years, **the stock of existing housing units at a point of time is very large as compared to the new residential investment in a year (i.e., flow of residential investment).** Second, **there is well developed resale market for housing units** so that people who construct or own them can sell them in this secondary market.
- **Residential investment depends on price of existing housing units. The higher the price of existing units, the higher will be investment in constructing and buying new housing units.**
- In the long run demand for housing is determined by rate of population growth and formation of new households. **The higher rate of population growth will lead to the increase in demand for housing units.** The tendency towards two-member households has led to greater demand for housing units.

- **Income is another important factor determining demand for houses and therefore greater residential investment.** Since level of income over time fluctuates a good deal, there is strong cyclical pattern of investment in residential construction.
- Finally, **interest is another important factor that determines demand for dwelling units.** Most houses, especially in cities, are purchased by borrowing funds from banks for a long time, say 20 to 25 years. Generally, the houses purchased are mortgaged with banks or other financial institutions who provide funds for this purpose.

3. **Inventory Investment:**

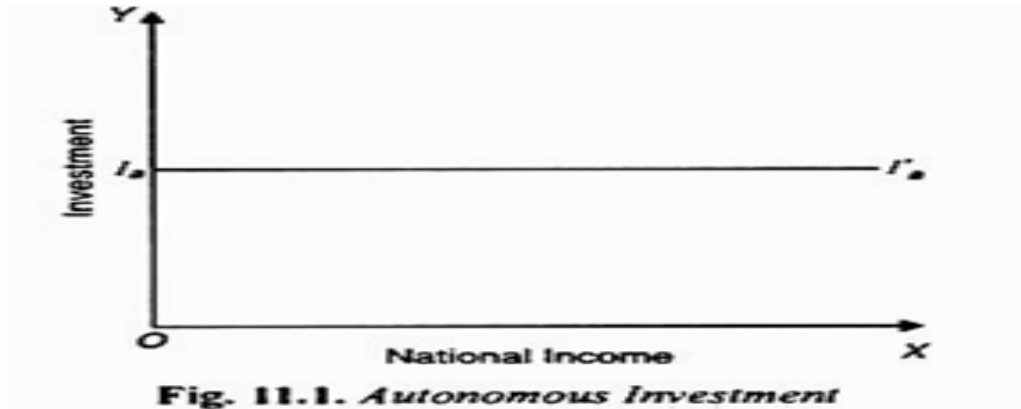
- Firms hold inventories of *raw materials, semi-finished goods* to be processed into final goods. The firms also hold inventories of finished goods to be sold shortly. **The change in the inventories or stocks of these goods with the firms is called inventory investment.**
- Now, why do firms hold inventories? **The first motive of holding inventories is smoothing of the level of production.**
- **The firms experience temporary booms and busts in sales of their output.** Instead of adjusting their production each time to match the changes in sales of the product they find cheaper to produce goods at a steady rate. With this steady rate of production when sales are low, the firms will be producing more than they are selling and therefore in these periods they will hold the extra goods produced as inventories. On the other hand, when sales are high with a steady rate of production, they will be producing less than they sell. In such periods to meet the market demand for goods, they will take out goods from inventories to meet the demand.

- The second reason for holding inventories is that it is less costly for a firm to buy inputs such as raw materials less frequently in large quantities to produce goods and therefore it is required to hold inventories of raw materials and other intermediate products. Buying small quantities of the materials more frequently to produce goods is a more-costly affair.
- The third reason for holding inventories by the firms is to **avoid 'running out of stock' possibilities** when their sales of goods are high and therefore it is profitable to sell at that time. This requires them to hold inventories of goods.

4. Autonomous Investment:

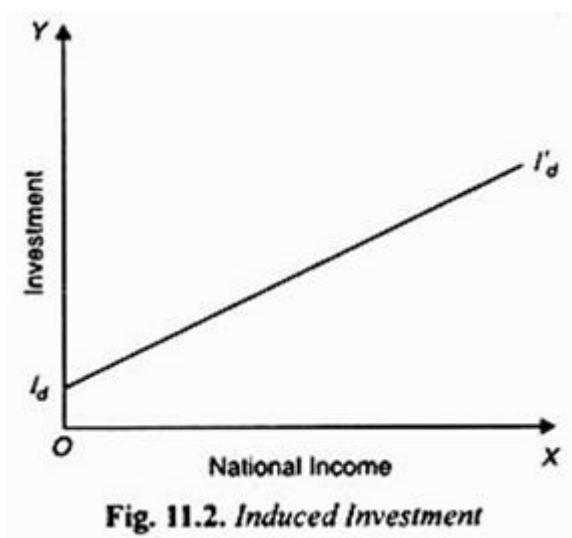
- By autonomous investment we mean the investment which does not change with the changes in the income level and is therefore independent of income.
- Autonomous investment refers to the investment which does not depend upon changes in the income level.
- This autonomous investment generally takes place in houses, roads, public undertakings and in other types of economic infrastructure such as power, transport and communication. This autonomous investment depends more on population growth and technical progress than on the level of income.
- Most of the investment undertaken by Government is of the autonomous nature.
- The investment undertaken by Government in various development projects to accelerate economic growth of the country is of autonomous type.

- The autonomous investment is depicted in Fig. 11.1 where it will be seen that whatever the level of national income, investment remains the same at I_a .
Therefore, **the autonomous investment curve is a horizontal straight line.**



5. Induced Investment:

- **Induced investment is that investment which is affected by the changes in the level of income.**
- The greater the level of income, the larger will be the consumption of the community. In order to produce more consumer goods, more investment has to be made in capital goods so that greater output of consumer goods becomes possible.
- Induced investment is shown in Fig. 11.2 where it will be seen that with the increase in national income, induced investment is increasing.



- . Increase in national income implies that demand for output of goods and services increases. To produce greater output, more capital goods are required to produce them. To have more capital goods more investment has to be undertaken. This induced investment is undertaken both in fixed capital assets and in inventories.

Ms. Simran Kaur
Assistant Professor
Department of Commerce
Yogoda Satsanga Mahavidyalaya