Edexcel (A) Economics A-level

Theme 2: The UK Economy, Performance and Policies

2.2 Aggregate Demand

2.2.3 Investment

Notes

Distinction between gross and net investment:

Gross investment: This is the amount that a firm invests in business assets that does not account for depreciations. A depreciation is when something starts to lose value, such as how a car loses value the older it gets. If the depreciation in the value of the capital is greater than the growth in gross investment, there is a decrease in the value of capital in the economy and there is no economic growth.

Net investment: This is the actual addition to the capital stock of an economy, after depreciations have been considered. Net investment= gross investment – depreciation.

Influences on investment:

The rate of economic growth

- If growth is high, firms will be making more revenue due to higher rates of consumer spending. This means they have more profits available to invest.

Business expectations and confidence

- If firms expect a high rate of return, they will invest more. Firms need to be certain about the future, otherwise they will postpone their investments.
- Also, expectations about society and politics could affect investment. For example, if a change in government might happen, or if commodity prices are due to rise, businesses may postpone their investment decisions.
- Keynes coined the term **animal spirits** when describing instincts and emotions of human behaviour, which drives the level of confidence in an economy.

Demand for exports

- This is related to the rate of market demand. The higher demand is, the more likely it is that firms will invest. This is because they expect higher sales, so they might direct capital goods into the markets where consumer demand is increasing.

Interest rates

- Investment increases as interest rates falls. This means that the cost of borrowing is less and the return to lending is higher.
- The higher interest rates are, the greater the opportunity cost of not saving the money.

- Moreover, high interest rates might make firms expect a fall in consumer spending, which is likely to discourage investment.

- **Access to credit**
  - If banks and lenders are unwilling to lend, such as shortly after the financial crisis when banks became more risk averse, firms will find it harder to gain access to credit, so it is either more expensive or not possible to gain the funds for investment.
  - Firms could use retained profits, however.
  - The availability of funds is dependent on the level of saving in the economy. The more consumers are saving, the more available fund are for lending, and therefore for investing.

- **The influence of government and regulations**
  - The rate of corporation tax could affect investment. Lower taxes means firms keep more profits, which could encourage investment.