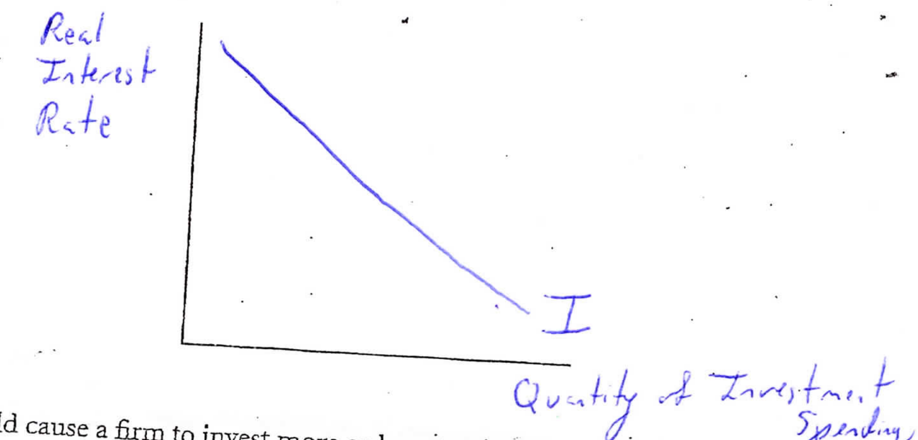
Investment Demand

Investment spending consists of spending on new buildings, machinery, plants, and equipment. Investment spending is a part of aggregate expenditures in the economy. Any increase in investment spending will necessarily increase aggregate expenditures (GDP) and AD.

Decisions about investment spending are based on a comparison of marginal cost and marginal benefit. If a firm expects a particular project to yield a greater benefit than cost, it will undertake it. An important cost associated with investment spending is the interest expense. Firms must either borrow money to engage in an investment project or use their own money. In either case, the interest rate determines the cost of the investment project. If the firm borrows money to invest, it must pay the interest rate to borrow. If the firm uses its own money, then it gives up the interest it could have earned by loaning that money to someone else. That is, the interest rate measures the opportunity cost if a firm invests with its own money.

5. Draw a graph illustrating an investment demand curve. Remember, the price paid to invest is the interest rate, so your graph should show the interest rate on the vertical axis, and the demand curve should have a slope that illustrates the relationship between the interest rate and the amount of investment a firm will undertake.



6. What factors could cause a firm to invest more or less at any given level of the interest rate? That is, what could cause the investment demand curve to shift (increase or decrease)?

2