4th Sem (M) Determinants of Investment (1)

The decision to invest in a new capital asset depends on whether the expected rate of return on the new investment is equal to or greater or less than the rate of interest to be paid on the funds needed to purchase this asset. It is only when the expected rate of return is higher than the interest rate that investment will be made in acquiring new capital assets.

There are three factors that are taken into consideration while making any investment decision. They are the cost of the capital asset, the expected rate of return from it during its lifetime, and the market rate of interest. Keynes sums up these factors in his concept of the Marginal Efficiency of Capital (MEC).

The Marginal Efficiency of Capital (MEC) is the highest rate of return expected from an additional unit of a capital asset over its cost. In the words of prof. Kurihara, "It is the ratio between the prospective yield of additional capital-goods and their supply price." The prospective yield (Y) is the aggregate net return from an asset during its life-time, while the supply price (P) is the cost of producing this asset.

Factors Other Than The Interest Rate:-

There are a no. of factors other than the rate of interest which affect the inducement to invest. They are the following :

(1) Element of uncertainty :- According to Keynes the MEC is more volatile than the rate of interest. This is because the prospective yield of capital assets depends upon the business expectations. These business expectations are very uncertain. It is difficult to calculate the expected annual returns on the life of a capital asset.

(2) Level of Income :- If the level of income rises in the economy through rise in money wage rates and other factor prices, the demand for goods will rise which will, in turn, raise the inducement to invest. Contrariwise, the inducement to investment will fall with lowering of income level.

(3) Consumer Demand :- The present and future demand for the products greatly influences the level of investment in the economy. If the current demand for consumer goods is increasing rapidly more investment will be made. Investment will be low if the demand is low and vice versa.

(4) Liquid Assets :- The amount of liquid assets with the investors also influence the inducement to invest. If they possess large liquid assets, the inducement to invest is high. This is especially the case with those firms which keep large reserve funds and undistributed profi

On the contrary, the inducement to invest is low for investors having little as liquid assets.

(5) Inventions and Innovations:- Inventions and innovations tend to raise the inducement to invest. If inventions and technological improvements lead to more efficient methods of production which reduce costs, the MEC of new capital assets will rise. Higher MEC will induce firms to make larger investments in the new capital assets. The absence of new technologies will mean low inducement to invest. An innovation also includes the opening of new areas and leading to new investment opportunities. Thus, inducement to invest rises.

(6) New products:- The nature of new products in terms of sales and costs may also influence their MEC and investment. If the sale prospects of a new product are high and the expected revenues more than the costs, the MEC will be high which will encourage investment in this and related industries.

(7) Growth of population:- A rapidly growing population means a growing market for all types of goods in the economy. To meet the demand of an increasing population in all brackets, investment will increase in all types of consumer goods industries. On the other hand, a declining

population results in a shrinking market for goods thereby lowering the inducement to invest.

(8) State policy :- The economic policies of the govt. have an important influence on the inducement to invest in the country. If the State leavy levies heavy progressive taxes on corporations, the inducement to invest is low and vice-versa. If the State follows the policy of nationalisation of industries, the private enterprise would be discouraged to invest. On the other hand, if the State encourages private enterprise by providing credit, power and other facilities, inducement to invest will be high.

(9) political climate :- political conditions also affect the inducement to invest. If there is political instability in the country, the inducement to invest may be affected adversely. A stable govt. creates confidence in the business community whereby the inducement to invest is raised. The danger of a revolution or war with some other country has an adverse effect on the inducement to invest whereas peace and prosperity tend to raise induce investment.

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