Investment

In an economic outlook, an investment is the purchase of goods that are not consumed today but are used in the future to generate wealth. In other words, investment is the value of fixed capital assets (plus stocks) produced in an economy over a period of time – investment refers to the creation of capital goods. Investment spending is an injection into the circular flow of income

There are three main types of investment which are as follows:

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. Business fixed investment is important in two respects.

First, business fixed investment is an important component of aggregate demand and therefore plays a significant role in the determination of natural income and employment. Secondly, Business fixed investment is a volatile component of aggregate demand which means that fluctuation in levels of fixed business investment is responsible for business cycles in a free market economy.

According to Keynes, business fixed investment is determined by:

(a) Expected rate of profit which he calls marginal efficiency of capital

(b) 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.

According to the neoclassical theory, business fixed investment is determined by:

(a) Marginal product of capital

(b) User's cost of capital. The user's cost of capital merely depends on the price of capital goods, the interest rate and the depreciation rate.

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.

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. 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 many factors;

Firstly, 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.

Secondly, 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.

Thirdly, Demand for residential investment Income is determined by the level of income. Since level of income over time fluctuates a good deal, there is strong cyclical pattern of investment in residential construction.

Fourthly, 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.

3. Inventory Investment:

The difference between goods produced (production) and goods sold (sales) in a given year is called inventory investment. In other words, inventory investment is the change in the stocks of materials, works in process, and finished goods within a firm, industry, or entire economy over a specified period of time.

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.

The inventory investment of raw materials and goods is determined by on the level of output which a firm plans to produce. An important model that explains the inventories of raw materials and goods is the accelerator model. According to the accelerator model, the firms hold the total stock of inventories of raw materials and goods that is proportional to their level of output.