

## 8.4: Investment Demand

### Learning Objective

1. Learn the determinants of investment demand and the effects of changes in these variables.

Investment demand refers to the demand by businesses for physical capital goods and services used to maintain or expand its operations. Think of it as the office and factory space, machinery, computers, desks, and so on that are used to operate a business. It is important to remember that investment demand here does not refer to financial investment. Financial investment is a form of saving, typically by households that wish to maintain or increase their wealth by deferring consumption till a later time.

In this model, investment demand will be assumed to be exogenous. This means that its value is determined outside of the model and is not dependent on any variable within the model. This assumption is made primarily to simplify the analysis and to allow the focus to be on exchange rate changes later. The simple equation for investment demand can be written as

$$I^D = I_0,$$

where the “0,” or naught, subscript on the right side indicates that the variable is exogenous or autonomous. In words, the equation says that investment demand is given exogenously as  $I_0$ .

Admittedly, this is not a realistic assumption. In many other macro models, investment demand is assumed to depend on two other aggregate variables: GNP and interest rates. GNP may affect investment demand since the total demand for business expansion is more likely the higher the total size of the economy. The growth rate of GNP may also be an associated determinant since the faster GNP is growing, the more likely companies will predict better business in the future, inspiring more investment.

Interest rates can affect investment demand because many businesses must borrow money to finance expansions. The interest rate is the cost of borrowing money; thus, the higher the interest rates are, the lower the investment demand should be, and vice versa.

If we included the GNP and interest rate effects into the model, the solution to the extended model later would prove to be much more difficult. Thus we simplify things by assuming that investment is exogenous. Since many students have learned about the GNP and interest rate effect in previous courses, you need to remember that these effects are *not* a part of this model.

### Key Takeaways

- In the G&S model, investment demand is assumed to be exogenous, meaning not dependent on any other variable within the model such as GNP or interest rates.
- The omission of an effect by GNP and interest rates on investment demand is made to simplify the model.

### exercise

1. **Jeopardy Questions.** As in the popular television game show, you are given an answer to a question and you must respond with the question. For example, if the answer is “a tax on imports,” then the correct question is “What is a tariff?”
  - Term for a type of investment by households that wish to maintain or increase their wealth by deferring consumption till a later time.
  - Investment demand refers to this type of goods and services.
  - Of *exogenous* or *endogenous*, this describes investment demand in the G&S model in the text.
  - The name of two variables that are likely to influence investment demand in reality but are excluded from the G&S model as a simplification.
  - A business purchase of a company delivery van would represent demand recorded in this component of aggregate demand in the G&S model.

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