Chapter 22

Put into practice questions

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Show using a diagram the likely effect on investment of a fall in business confidence.

This shifts the investment schedule downwards; lower returns expected at every level of investment tomorrow

Using an aggregate supply and aggregate demand diagram, show the effect of an increase in investment on aggregate demand and aggregate supply.

It increases aggregate demand and shifts it outwards. Over time greater capacity and investment shifts aggregate supply outwards.

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If demand for capital goods is very sensitive to interest rate changes, does this mean that it is interest elastic or interest inelastic?

Interest elastic

Calculate the interest elasticity of investment if investment falls 20 per cent when interest rates increase 4 per cent.

-20/+4= -5

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There will be a movement down a given marginal efficiency of investment schedule when:

- Managers become more optimistic. No, this causes a shift in the investment schedule
- Managers become more pessimistic. No, this causes a shift in the investment schedule
- The rate of interest falls. True; there will be a movement along and increase in investment
- The rate of interest rises there will be a movement along and decrease in investment

There will be an outward shift in the marginal efficiency of investment schedule when:

- Managers become more optimistic. True

- Managers become more pessimistic. No
- The rate of interest falls. Movement along
- The rate of interest rises. Movement along

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Can you remember the equation for the multiplier?

Answer is: 1/(1-mpc)

How does the multiplier link investment to aggregate demand?

An increase in investment leads to an increase in demand and a bigger increase in output and income

On what does the size of the multiplier depend?
The marginal propensity to consume

End of chapter put into practice questions

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Draw two marginal efficiency of capital curves; one that is interest elastic and one that is interest inelastic.

Interest elastic will be flatter than the interest inelastic.

Show the effect of greater business optimism on the marginal efficiency of capital and on aggregate demand and equilibrium price and output.

It increases the expected returns shifting the marginal efficiency outwards.
This increases aggregate demand and should lead to higher equilibrium price and output.

Show the effect on aggregate demand and national income equilibrium of an increase in investment.

It increases aggregate demand and should lead to a higher price and output.

Show the effect on aggregate supply and national income equilibrium of an increase in investment.

It shifts aggregate supply outwards.

The relationship between the growth of national income and the resulting increase in investment is known as the:

Answer is A: accelerator

When is cost–benefit analysis most likely to be used?

Answer is C: By a government choosing between two locations for an airport

If the MPC is 0.8 and investment increases £100 billion how much might national income be expected to increase?

Multiplier = 1/ (1-0.8) = 5; national income will increase by 5 *100=£500 billion

If an increase in investment of £20 billion increases national income by £40 billion what is the marginal propensity to consume?

Multiplier is 2. This means MPC is 0.5

If the economy is in equilibrium and government spending = £45 billion, Export spending = £70 billion, Savings = £50 billion, Taxation revenue = £60 billion, Import spending = £25 billion, what is the value of investment spending?

For equilibrium: I+G+X=S+T+M
I + 45+ 70= 50+60+25
I +115= 135
I= £20 billion