

Core Macroeconomics

Hillary Term 2008

Week 4: Investment

Reading

Investment is an important and volatile component of aggregate demand, as well as an important determinant of income per capita in the long-run. Romer (1996)** chapter 8 presents a readable introduction to this topic, see also Burda & Wyplosz (2005) chapter 6 and Mankiw (2005) chapter 17 for background material. Begg (1982)** chapter 7 discusses the application of rational expectations to investment. Another interesting paper is Dixit (1992)**. Finally, read Nickell (1978)** chapters 1–3. Hay & Morris (1991) chapters 11 and 12 provide an industrial economics view of the issue. You may also wish to look at the articles in the *Oxford Review of Economic Policy* issue of Summer 1996, especially Bond & Jenkinson (1996), which provides an applied UK perspective.

Take notes on:

1. Marginal Productivity of Capital and the Optimal Capital Stock *and* Why must the interest rate be a relevant determinant of investment? How far does the empirical evidence give support to its importance?
2. The Accelerator and Flexible Accelerator
3. Tobin's q .
4. The effect of permanent and temporary changes in output, cash flow, interest rates and taxes on investment.
5. Investment and irreversibility
6. The Modigliani-Miller theorem *and* how does the investment rate in the UK compare with other advanced economies?

Class Assignment

Prepare a short presentation and detailed notes on your assigned topic (see syllabus for schedule) and be prepared to give a presentation in class. Also remember to bring copies for your cohort.

Peer Reviewed Essay

Everyone should produce a standard length essay due Friday Week 4 by 6PM. I will exchange these among you over the weekend and you should provide comments on the essay, highlighting strengths and weaknesses. Please return the essays and marks to me by Wednesday 6PM in Week 5.

“Business investment is highly pro-cyclical. Explain how such behavior is accounted for by rival theories of investment and evaluate how well they do so.” (2001).

Recent Essays

“Since business investment is determined by expected profits the explanation for low UK investment must be low rates of return.” Discuss (2006)

“Investment theory is unsatisfactory because too little attention is paid to the modelling of business expectations” Discuss. (2004)

“Aggregate consumption varies less than GDP, while aggregate investment varies more than GDP. Is this consistent with the assumption that consumption and investment decisions result from rational choices made by forward-looking agents?” (1999)

“The main economic theories of investment are inadequate”. Discuss. (1998)

References

- Begg, D. K. H. (1982), *The Rational Expectations Revolution in Macroeconomics: Theories and Evidence*, Philip Allan.
- Bond, S. & Jenkinson, T. (1996), ‘The assessment: investment performance and policy’, *Oxford Review of Economic Policy* 12(2), 1–29.

- Burda, M. & Wyplosz, C. (2005), *Macroeconomics: A European Text*, Oxford University Press.
- Dixit, A. (1992), 'Investment and hysteresis', *Journal of Economic Perspectives* **6**(1), 107–132.
- Hay, D. A. & Morris, D. J. (1991), *Industrial Economics and Organization : Theory and Evidence*, Oxford University Press.
- Mankiw, N. G. (2005), *Macroeconomics*, Worth Publishers.
- Nickell, S. J. (1978), *The Investment Decisions of Firms*, Cambridge University Press.
- Romer, D. (1996), *Advanced Macroeconomics: Third Edition*, McGraw-Hill.