Investment Demand

Investment spending consists of spending on new buildings, machinery, plant and equipment. Investment spending is a part of total spending or aggregate expenditures. Any increase in investment spending would necessarily increase total spending or aggregate expenditures.

Decisions on investment spending are based on a comparison of marginal cost and marginal benefit: If you expect a particular project to yield a greater benefit than cost, you will undertake it. One of the costs associated with investment spending is the interest expense on borrowed money to engage in the project.

Part A

1. Figure 22.1 lists the expected cost of various projects and the associated expected benefit. Fill in the decision column with Yes if you would undertake the project and No if you would not. The first example has been completed for you.

Figure 22.1

Comparison of Costs and Benefits of Different Projects

Cost	Benefit	Decision
$65	$20	No
$55	$30	
$45	$40	
$35	$50	
$25	$60	

2. If interest rates fell and the cost associated with the project fell by $15 at each level, indicate in Figure 22.2 which projects you would undertake. The first example has been completed for you.

Figure 22.2

Comparison of Project Costs and Benefits with Decrease in Costs

Cost	Benefit	Decision
$50	$20	No
	$30	
	$40	
	$50	
	$60	

Activity written by James Chasey, Homewood-Flossmoor High School, Flossmoor, Ill.

Part B

Figure 22.3 lists the dollar value of investment projects that would be profitable at each interest rate.

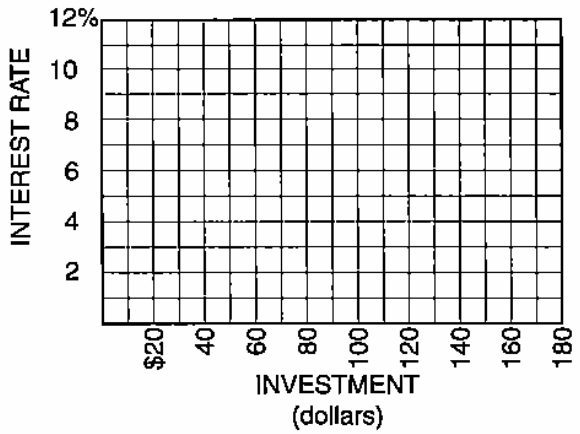
Figure 22.3

Country A and Country B Investment Data

Interest Rate	Country A Investment	Country B Investment
10%	$10	$70
8	50	75
6	90	80
4	130	85
2	170	90

Figure 22.4

Investment Demand Curves



3. Plot the investment demand curve for Country A on Figure 22.4 and label it I_A.

4. Plot the investment demand curve for Country B on Figure 22.4, and label it I_B.

5. Which country would experience the larger increase in the amount of investment spending if interest rates in each country dropped from 8 percent to 6 percent?

6. How would you characterize the responsiveness of investment spending to the interest rates in Country A compared with Country B?

7. Assuming an MPC of 75 percent, what would be the effect on real GDP in Country A and Country B if real interest rates decline from 8 percent to 6 percent?

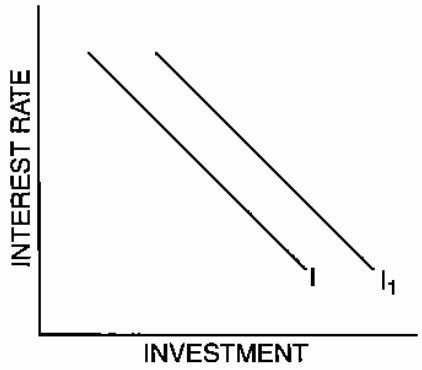
8. What conclusions can be reached about the elasticity of the investment demand curve and the effect a given change in interest rates would have on equilibrium real GDP?

9. Looking at the graph you drew, the investment demand curve is downward sloping in both Country A and Country B. Why does the investment demand curve have a downward slope?

Part C

Use Figure 22.5 to help answer questions 10, 11 and 12.

Figure 22.5
Shift in Investment Demand Curve



10. If interest rates rise, will the investment demand curve shift to a new location? If so, in what direction?

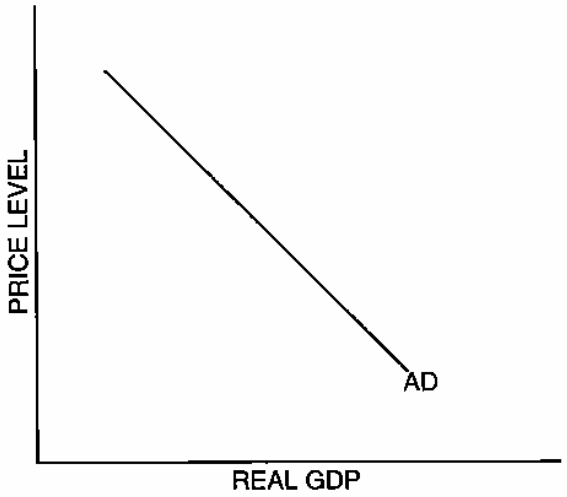
11. The shift in the investment demand curve shown in Figure 22.5 (I to I_1) represents a new location for the entire curve. How would you interpret the difference between movement along an existing investment demand curve and a shift in the location of the curve?

12. List two factors that could cause a shift in the investment demand curve as shown in Figure 22.5.

An Introduction to Aggregate Demand

Part A
Why Is the Aggregate Demand Curve Downward Sloping?

Figure 23.1
Aggregate Demand Curve



1. According to the AD curve, what is the relationship between the price level and real GDP?

2. Explain how each of the following effects helps explain why the AD curve is downward sloping.

   (A) Interest rate effect

   (B) Wealth effect or real-balance effect

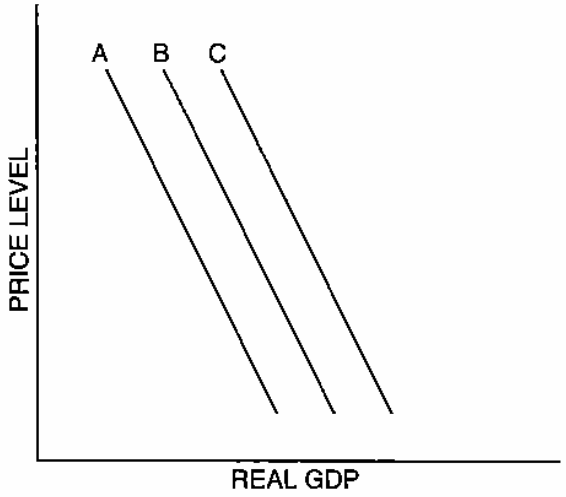
   (C) Net export effect

Activity written by John Morton, National Council on Economic Education, New York, N.Y.

3. In what ways do the reasons that explain the downward slope of the AD curve differ from the reasons that explain the downward slope of the demand curve for a single product?

Part B
What Shifts the Aggregate Demand Curve?

Figure 23.2
Shifts in Aggregate Demand



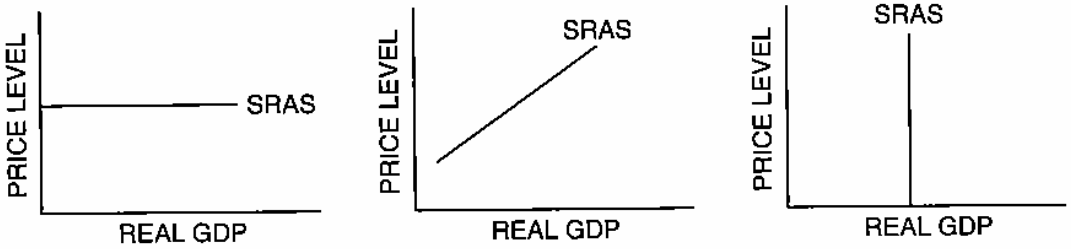
4. Using Figure 23.2, determine whether each situation below will cause an increase, decrease or no change in AD. Always start at curve B. If the situation would cause an increase in AD, draw an up arrow in column 1. If it causes a decrease, draw a down arrow. If there is no change, write NC. For each situation that causes a change in aggregate demand, write the letter of the new demand curve in column 2. Move only one curve.

Situation	1. Change in AD	2. New AD Curve
(A) Congress cuts taxes.		
(B) Autonomous investment spending decreased.		
(C) Government spending to increase next fiscal year; president promises no increase in taxes.		
(D) Survey shows consumer confidence jumps.		
(E) Stock market collapses; investors lose billions.		
(F) Productivity rises for fourth straight year.		
(G) President cuts defense spending by 20 percent; no increase in domestic spending.		

An Introduction to Short-Run Aggregate Supply

Part A
Why Can the Aggregate Supply Curve Have Three Different Shapes?

Figure 24.1
Possible Shapes of Aggregate Supply Curve



1. Under what conditions would an economy have a horizontal SRAS curve?

2. Under what conditions would an economy have a vertical SRAS curve?

3. Under what conditions would an economy have a positively sloped SRAS curve?

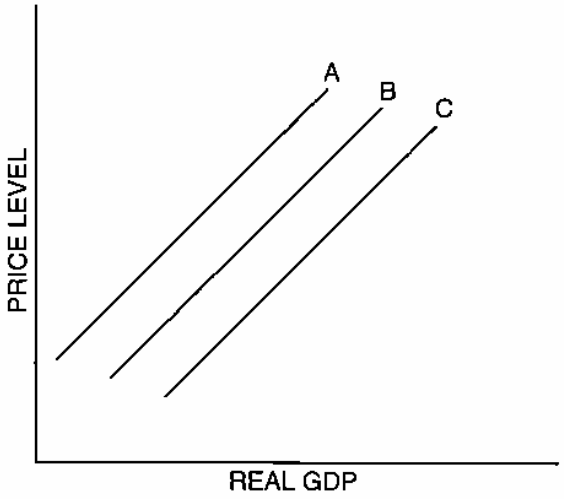
Activity written by John Morton, National Council on Economic Education, New York, N.Y.

4. Assume AD increased. What would be the effect on real GDP and the price level if the economy had a horizontal SRAS curve? A positively sloped SRAS curve? A vertical SRAS curve?

5. What range of the SRAS curve do you think the economy is in today? Explain.

Part B
What Shifts the Short-Run Aggregate Supply Curve?

Figure 24.2
Shifts in Short-Run Aggregate Supply



6. Using Figure 24.2, determine whether each situation below will cause an increase, decrease or no change in short-run aggregate supply (SRAS). Always start at curve B. If the situation would cause an increase in SRAS, draw an up arrow in column 1. If it causes a decrease, draw a down arrow. If there is no change, write NC. For each situation that causes a change in SRAS, write the letter of the new curve in column 2. Move only one curve.

Situation	1. Change in SRAS	2. New SRAS Curve
(A) Unions grow more aggressive; wage rates increase.		
(B) OPEC successfully increases oil prices.		
(C) Labor productivity increases dramatically.		
(D) Giant natural gas discovery decreases energy prices.		
(E) Computer technology brings new efficiency to industry.		
(F) Government spending increases.		
(G) Cuts in tax rates increase incentives to save.		
(H) Low birth rate will decrease the labor force in future.		
(I) Research shows that improved schools have increased the skills of American workers and managers.		