Capital

Man made items used in the production of goods and services

Types of Capital

- **Social Capital**
    - The assets owned by the community/society in general. Eg hospitals, parks roads
- **Fixed Capital**
    - A business' stock of fixed assets. Eg plant, equipment, tools
- **Private Capital**
    - Assets owned by individuals. Eg Computers, cars

Interest

- **The payment for capital is interest**
    - The reason for this is because those who sacrifice present consumption (by choosing to save) must be rewarded by those who need funds for present use (borrowers).
        - If the owner of a firm wants to buy equipment for €200,000, they may need a loan
        - The bank collects €200,000 from its savers and gives it to the firm
        - The savers need to be rewarded with interest in order to part with their money

- **Determining the Interest Rate**
    - ***Classical Theory of Loanable Funds***
        - **The market for loanable funds**
            - The market in which those who want to save supply funds and those who want to borrow to invest demand funds
        - The supply of loanable funds comes from national saving, including both private and public saving. The demand for loanable funds comes from firms and households that want to borrow for the purposes of investment
        - The interest rate is the price of a loan and the reward for saving.
        - As the interest rate rises demand for loans decreases and the supply of loans increases
        - As the interest falls, demand for loans increases and supply of loanable funds decreases.
        - According to the theory the interest rate brings supply and demand for funds into equilibrium

- ***<u>Liquidity Preference Theory (Keynes)</u>***
  - In his book, *The General Theory of Employment, Interest and Money*, John Maynard Keynes proposed a theory to explain the factors that determine the interest rate in an economy. According to the theory the interest rate adjusts itself to bring the quantity of money supplied and money demanded into balance.
    - **Money Supply**
      - According to Keynes' theory the money supply is set by the central bank and they can alter it through open market operations. Because the money supply is set by the central bank, the supply does not depend on other economic variables, in particular the interest rate.
    - **Money Demand**
      - According to Keynes people hold/demand money for the following reasons. The interest rate has varying degrees of influence on the following motives for holding money:
        - **Transactionary motive**
          - People desire to hold money for day-to-day expenses e.g.buying goods & services
          - The transactionary motive is influenced by the level of income, nature and quantity of purchases (MPC)
        - **Precautionary motive**
          - People desire to hold money for emergencies/rainy day e.g. illness, house repairs.
          - Influenced by the level of income, recent spending, slightly by interest rates, MPS
        - **Speculative motive**
          - People desire to hold money for any possible profitable future investment opportunities.
          - Interest Rates, Returns in Stock/Bond markets, MPS
      - ***Determining the Interest Rate***
        - The interest rate is the opportunity cost of holding money. If you hold cash, you are foregoing the interest you could earn in a deposit account
        - When the interest rate increases the opportunity cost of holding cash increases, therefore there is more of an incentive to part with your money and put it on deposit. The opposite is true of decreasing interest rates

- If the money quantity of money demanded by people is less than the money supplied by the central bank, such as interest rate, R1, the rate will start to drop. The high interest rate (high opportunity cost of holding money) encourages people to part with their extra money and pushes the interest rate downwards the equilibrium.
- If the quantity of money demanded by people is greater than that supplied by the central bank, such as at interest rate R2, the rate will start to rise. The low interest rate (low opportunity cost of holding money) means people are not inclined to part with their money therefore the interest rate must rise towards the equilibrium in order for this to occur.
- The forces of supply and demand in the market for money push the interest rate towards the equilibrium interest rate, at which people are content holding the quantity of money the central bank has created.

- **<u>Effects of a fall in interest rates on each of the motives</u>**
  - **Transactionary**
    - The demand for money for transactionary reasons is **not affected** by the fall in the rate of interest. Why? People need to have cash for day-to-day spending and this, allied to their level of income, not rates of interest determines the motive.
  - **Precautionary**

        - The demand for money for precautionary reasons is affected slightly (negatively) by the rate of interest. Why? As interest rates fall slightly more money will be held for precautionary purposes, due to the opportunity cost of lower rates of interest.
    - **Speculative**
        - The demand for money for speculative reasons is greatly affected (negatively) by the rate of interest. Why? As interest rates fall more money will be held for speculative purposes as people will hold more wealth in cash form to profit from future higher rates of interest.

Marginal Efficiency of Capital

Definition: The extra profit earned as a result of employing an extra unit of capital. i.e. the MRP of the capital less the cost of the capital.

- **Factors that influence the MEC**
    - **Cost of the Capital**
        - The higher the cost of the capital item the greater then revenue that will have to be generated to cover the cost. A machine purchased for €1 million will require far more revenue to cover its cost than a machine purchased for €1000.
    - **Rate of Interest**
        - The higher the interest rate on the borrowed money used to purchase the capital, the less efficient the capital as higher revenue will need to be generated to cover the higher interest rates.
    - **Selling Price of the Goods**
        - As selling prices in a firm drops the less efficient the capital become as the ratio of marginal revenue to capital cost dis-improves when selling prices drop.
    - **Wear and Tear**
        - As a capital item ages it can suffer from wear and tear and have periods when it is not in use because of repairs. The older capital items become the less output they generate.

- **Capital Widening versus Capital Deepening**
    - **Capital Widening:** An increase in the capital stock, which leave the capital/labour ratio unchanged.
    - **Capital Deepening:** An increase in the capital stock, which improves the capital/labour ratio

Savings

Definition: Income not spent in the economy

- **Factors Influencing the rate of saving**

- **DIRT**
  - The higher the rate of Deposit Interest Retention Tax, the less likely people are to save. The current rate is 41%.
- **Income Levels**
  - As income levels fall people will save less money as they will need a higher portion of their income to cover essentials.
- **Real Interest Rates**
  - As interest rates fall people are less incentivised to save as the return is poor. Also, if inflation is high the real interest rate may mean that savers are getting very little return, which discourages them from saving.
- **Future Expectations for the economy**
  - People are concerned about the future of the economy which is affecting consumer confidence. As a result people are tending to postpone purchasing and save instead.
- **Security of savings**
  - Due to the current economic climate people are less inclined towards risky investments and prefer the security of state backed savings.
- **Quality of financial products**
  - If the products available produce reasonable returns then people are more likely to use them as a form of saving. Due to the banking crisis consumers are seeking greater security for their savings e.g. An Post’s ‘National Solidarity Bond’.
- **Deferred spending**
  - Though income levels are falling (unemployment is rising and those in employment have reduced disposable incomes due to higher tax rates), deflation is occurring, consumers are spending less and are deferring spending until later. This results in forced savings.
- **Future Levels of state benefits**
  - The state faces an increasing pensions' bill for public servants. People are fearful for their future pensions and this may be contributing to increasing savings currently.

- **Effects on an increasing rate of saving**
  - **Reduced spending within the economy / leakage from circular flow of income.**
    - People who save more spend less and so the demand for goods and services may fall.
  - **Increase in unemployment.**
    - Falling demand for goods and services will result in a reduction in demand for labour resulting in increased unemployment.
  - **More funds available for investment.**
    - Increased savings will mean that more funds are available in financial institutions for borrowing by individuals and businesses. This may help economic growth.
  - **Reduced inflation.**

        - With less spending and falling demand there will be reduced pressure on prices resulting in lower inflation and, possibly, increased competitiveness.
    - **Reduced demand for imports.**
        - Less spending may mean reduced demand for imports thereby helping to improve our Balance of Payments.
    - **Increased revenue for government.**
        - More savings mean increased revenue from DIRT to the government.
    - **Stabilise banking sector.**
        - Increased savings result in increased funds available to banks. This may lead to increased stability in the banking sector at a time when confidence needs to be restored.

Investment

Definition: The production of capital goods or the addition to capital stock in the economy

- **Importance of Investment for the Irish Economy**
    - **Increased productive capacity**
        - Greater investment allows the country to produce more output / it replaces worn-out capital resources.
    - **Increased labour productivity**
        - More investment allows labour to become more efficient. Investment allows workers to use more up-to-date capital goods, making them more efficient.
    - **Increased employment**
        - Extra investment increases aggregate demand resulting in the demand for more employees to meet this additional demand for goods & services.
    - **Increased GNP**
        - Increased investment leads to higher GNP, greater demand, increased spending and a higher standard of living.
    - **Investment generates future wealth for the economy**
        - Investment into the economy means that we are safeguarding the future wealth creating capacity of the country, by ensuring that we have capital goods in the future.
    - **Increased Government Revenues**
        - An increase in investment will increase economic activity. This will generate additional revenues for the government for use within society.

- **Factors that Influence the level of Investment**
    - **Rates of interest / Cost of borrowing**
        - As rates of interest increase, the cost of borrowing increases. Thus the lower will be the profit earned. Hence investment will fall / MEC may fall.
    - **Business people's expectations**

    - Currently many business people are pessimistic about the economy and so they are less likely to invest. Irish business people are more pessimistic about the future for various reasons: potentially higher tax rates in Ireland; higher interest rates; poor economic growth rates.
- **Government economic policies**
    - If government policy is favourable towards investment then investment tends to rise. Examples of favourable policies currently include: attractive state grants; a policy to maintain corporation tax at current levels; continued development of infrastructure etc. The government policy to provide additional training places; reduced VAT for some industries and reduced PRSI for additional workers hired may help attract investment into Ireland.
- **The international economic climate**
    - Ireland is an open economy, which relies on foreign investment. If the international economic climate is in a slump then this may result in a fall in demand which will cause Irish businesses to suffer.
- **The Marginal Efficiency of Capital**
    - The greater the potential MEC for any possible investment project then the more likely the investment will take place.
- **Stability in the banking sector**
    - The policy of the state to stabilise the banking sector should help the flow of credit, and so encourage risk taking.
- **The cost of capital goods**
    - The greater the cost of capital goods the lower the profitability of the investment, hence investment tends to fall.
- **Availability of a skilled English speaking workforce**
    - The workforce is English speaking which may attract investment. People have time to re-train during the current period of unemployment. Ireland currently has a pool of highly skilled workers.