B.A PART 2

INVESTMENT FUNCTION AND M.E.C

MACRO ECONOMICS

**Marginal Efficiency of Capital (MEC)**!

Since the marginal efficiency of capital is expressed as a ratio, it can be compared directly with the rate of interest. Such comparison is essential, because private investment on capital assets depends upon a rational comparison of the expected rate of profit and the rate of interest. Such a comparison is in effect between the supply price of an asset and its demand price.

The demand price of an asset is defined as a sum of the expected future yield (that is, the series of prospective annual yields) discounted at the current rate of interest.

Thus, demand price = sum of prospective yields discounted at the current rate of interest whereas supply price = sum of prospective yields discounted by the MEC.

**Symbolically,**

**the demand price of an asset is:**

DP = Q1/ (1+i)+ Q2/ (1+i)2+ Q3/ (1+i)3+…+ Qn(1+1)n

Where DP represents the demand price.

Q1… Qn the prospective yield or annuities, and i the current rate of interest.

Thus, the demand price of an asset is its true present market value. Suppose, for instance, the market value of an asset, which promises to yield Rs. 1,100 at the end of one year and Rs, 1,210 at the end of two years, will be estimated at higher than Rs. 2,000 when the interest rate is less than 10 per cent (i.e., rate of MEC.) For example, if the market rate of interest is 5 per cent, the capital asset will have the present value of:

1,100/ 1.05 + 1,210/ (10.5)2 = 1,047.62 + 1,097 = 2, 144.62.

This is what Keynes called the demand price of a capital asset.

From the example just mentioned, it is easy to see that the greater the demand price, the lower is the current rate of interest at which it is discounted. Evidently, the lower the rate of interest, the greater will be the number of capital assets for which the demand price will exceed the supply price and the greater the inducement to invest.

The marginal efficiency of capital will be greater than the rate of interest, and consequently, new investment in capital goods will prove profitable till the supply price, i.e., cost of production, remains less than the demand price. A comparison between the supply price and demand price of a capital asset is clearly expressed

**The effect of the relative positions of demand and supply on the behavioural tendency of the entrepreneurs regarding inducements to invest may be generalized as follows:**

1. When -the MEC = rate of interest (i) or SP = DP, the effect is neutral.

2. When the MEC> i, or DP > SP, the effect will be favourable.

3. When the MEC < i, or DP < SP, there will be an adverse effect.

This implies that the rate of interest as well as the marginal efficiency of capital must be known before the volume of investment is determined by the entrepreneurs. However, these two strategic variables are determined independently of each other; the marginal efficiency of capital is the result of the supply price and the prospective yields of assets, and the rate of interest depends upon the liquidity preference function and the money supply.

It is wrong to conclude that since investment will be carried to the point at which the marginal efficiency of capital becomes equal to the rate of interest, both these rates depend upon the same thing or are interdependent.

In fact, both are independent variables, and investment is dependent upon them. Investment increases when MEC exceeds the rate of interest (i) and continues to rise till the MEC = i. It should be noted here that changes in the volume of investment directly affect the marginal efficiency of capital but not the rate of interest. As we shall see later on, the MEC declines as the rate of investment increases.