Essay Question 21

(AD components – effects of consumption and investment on economic growth)

**The Singapore economy has turned in a strong performance in the first quarter of 2006. Indicators point to continued growth in the next few quarters. This improvement reflected stronger external demand and sustained growth in domestic demand. Consumption and investment rose at a more moderate place while businesses continue to draw down on inventories.**

Economic Survey of Singapore first quarter 2006

**Discuss the role of consumption and investment in ensuring a continued growth in the economy. [15]**

Introduction

Definition of economic growth, consumption and investment.

State that the economic growth of an economy can be affected by the change in the level of consumption and investment expenditure and they can both affect the actual and potential growth of the economy.

Main body

1. Explain how the rise in actual consumption and investment expenditure will lead to a rise in national income (Real GDP) based on the conception of AD and AS analysis.

Increase in C and I will increase the level of AD – via the multiplier process - increase the level of national income (need to explain the multiplier process and draw the diagram to depict the rise in real GDP)

As for investment, it can raise the potential growth when it is used to expand the capacity of resources in the economy.

2. Evaluate the extent of the contribution of the consumption and investment to economic growth.

* Consumption is the source of market demand that will induce production as producers are producing the goods for the consumption market.
* The need to satisfy a demanding consumer market will prompt the producers to be more efficient and innovative so as to ensure that they can increase their market share in the economy. To be more efficient, the producers will raise the productivity of their production and this will induce the efficiency of the industry. To be innovative, the producer will involve in research and development to provide a wider variety of quality products which will widen the scope of production for the industries. By virtue of these efforts, the level of actual and potential growth of the economy will be raised.
* As for investment, it is one of the critical components of AD which will induce a higher level of national income.
* It also raises the efficiency and innovation of the economy when the investment is seen in term of R & D which is critical in expanding the actual and potential growth of the economy.
* Investment expenditures will also induce the mobility of resources which enable the expansion of resource capacity that will promote potential growth when the investment is made in the area of infrastructural development.
* Investment spent on the development of technology and education of the population will raise productivity and efficiency of the economy.

3. Evaluate the effectiveness of the two components in continued growth for the economy

The rise in consumption and investment expenditure will increase the level of national income through the multiplying effect which will then raise the disposable income of the people in the economy and thus, this will induce a rise in the level of investment since more goods must be produced to meet the rising demand due to higher level of consumption as seen in the accelerator effect. Thus the continuous rise in the level of investment which will lead to rise in national income and further induce the growth of consumption will provide a continued growth of investment will then create a cyclical perpetual growth of the economy.

The continued growth can also be seen from how the rise in aggregate demand by virtue of growth in consumption that induce growth in production which will be kept on a continual basis as the investment expenditure will provide the expansion of resource capacity that sustain the continuation of growth of economy.

*Why the continual growth of the economy is not feasible?*

* Small multiplying effect – cannot create a substantial growth of the national income to induce a substantial growth of investment expenditure
* Growth of the national income is temporary and thus the level of investment may not increase as the investor will rather increase the utilization of resource at an over-capacity than to experience excess stocks when the demand falls as it is not a permanent rise in demand.
* Lack of resources in the existing capacity of production and thus the rising cost condition will discourage investment.

Conclusion

In conclusion, the role of consumption and investment expenditure is of great significance to the growth of the economy. However, it is not very feasible for these two AD components to sustain continual growth as its influence on the economy can be limited under certain circumstances.