

Investment (I): what it is and why it matters

Investment is firms spending on capital goods, such as machinery, factories, technology and infrastructure.

Investment matters because it can increase the economy's productive capacity (LRAS), supporting potential economic growth.

It is also usually the most volatile component of aggregate demand, so it can drive big swings in the economic cycle.

For example, UK whole economy investment stood at 18.6% of GDP in late 2025, the lowest ratio among all G7 nations.

Gross, net investment and depreciation

Gross investment

Gross investment is total spending on capital goods. Some of this spending simply replaces worn out or outdated capital, rather than expanding capacity.

Depreciation

Depreciation is the fall in value of existing capital over time due to wear and tear or becoming obsolete. If firms only replace old machines, productive capacity may not rise unless the new capital is significantly more productive.

Net investment

Net investment measures the true increase in the capital stock and is the best indicator of extra future capacity.

Net investment = Gross investment – Depreciation

What determines investment

Economic growth and the accelerator effect

When national income is rising quickly, firms capacity utilisation increases and they are more likely to expand capacity to meet demand. This can cause investment to rise faster than GDP growth, known as the accelerator effect.

In a recession, firms often have spare capacity, so they cut back investment sharply. For example UK business investment fell by 1.1% in Q2 2025 as firms hit "spare capacity".

Interest rates

Most investment is funded by borrowing, so lower interest rates reduce the cost of loans and tend to encourage investment. Higher interest rates also increase the opportunity cost of investing retained profits, because firms could earn higher returns by saving or buying financial assets instead.

Overall, higher interest rates usually lead to lower investment.

For example, as IR were cut to 3.75% in late 2025, one-third of UK businesses reported that lower borrowing costs were their primary reason for green-lighting new capital projects.

Business expectations and confidence

Firms invest when they expect strong future demand and profits. If growth slows or uncertainty rises, expected profits fall and firms may delay or cancel investment projects.

Keynes argued that decisions are often influenced by shifts in optimism and pessimism, sometimes called “animal spirits”, so investment can change even without large changes in underlying conditions.

Access to credit

Even if interest rates are low, investment can still fall if banks restrict lending, such as during a credit crunch. Easier access to credit tends to raise investment, while tighter credit conditions reduce it.

External demand and the exchange rate

If global demand for exports increases, firms may invest to expand output. A depreciation can strengthen this incentive by making domestic goods and services cheaper to foreign buyers, raising export demand.

Government policy and regulation

Policies that raise post-tax returns or reduce the cost of capital can encourage investment, such as lower corporation tax or investment allowances. However, unstable or overly complex regulation can increase risk and compliance costs, discouraging firms from investing.

For example, the government recently announced **40% First-Year Allowance (FYA)**. This is a tax incentive that lets businesses instantly deduct 40% of a new asset's cost from their taxable profits, in an attempt to boost **investment**.