Exercise walk-through

Real Interest Rates and International Capital Flows ▪ 6.6

eXercise

You must be able to

- explain how a higher domestic **real interest rate** attracts foreign **capital inflows** **资本流入**
- relate capital flows to demand for the currency and the exchange rate
- connect the **financial account** to the **current account** through these flows

Method — Interest rates and capital flows

A higher domestic **real interest rate** offers investors a better return, so **capital flows in** from abroad.

Method — Capital flows and the currency

Those inflows **raise demand** for the domestic currency, so it **appreciates**.

Method — Linking the accounts

Capital inflows are recorded in the **financial account** and are the flip side of the **current account** — the two broadly offset.

Practice 2.1 ▪ 1 mark

State the effect of a higher domestic real interest rate on capital flows.

Solution 2.1

Method: Interest rates and capital flows

Worked steps

it attracts capital inflows B1.

Practice 2.2 ▪ 1 mark

State how capital inflows affect the demand for the currency.

Solution 2.2

Method: Capital flows and the currency

Worked steps

it raises the demand for the currency **B1**.

Practice 2.3 ▪ 1 mark

State the connection between the financial account and the current account.

Solution 2.3

Method: Linking the accounts

Worked steps

they broadly offset each other (a financial-account surplus matches a current-account deficit) **B1**.

Exam-style 3.1 ▪ 1 mark

A higher domestic real interest rate attracts

- **A** capital outflows
- **B** capital inflows
- **C** more imports
- **D** lower saving

Solution 3.1

Method: Interest rates and capital flows

A capital outflows

B capital inflows ✓

C more imports

D lower saving

Worked steps

B.

Exam-style 3.2 ▪ 1 mark

Capital inflows ________ the demand for the domestic currency.

A raise

B lower

C do not change

D remove

Solution 3.2

Method: Capital flows and the currency

A raise ✓

B lower

C do not change

D remove

Worked steps

A.

Exam-style 3.3 ▪ 1 mark

A country raises its real interest rate above the world rate.

(a) State the effect on capital flows.

(b) State the effect on the demand for its currency.

(c) State the effect on the exchange rate.

Solution 3.3

Method: Interest rates and capital flows

Worked steps

(a) capital flows in **B1**. (b) it rises **B1**. (c) the currency appreciates **B1**.