

6.6 Real Interest Rates and International Capital Flows

Name: _____ Class: _____ Date: _____

Total: 8 marks

Objective

Build the skills to answer exam questions on **real interest rates and international capital flows**.

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

1 Worked examples

Study these first. Each one shows the method for a question type used later.

■ Interest rates and capital flows

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

■ Capital flows and the currency

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

■ Linking the accounts

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

2 Practice

2.1 State the effect of a higher domestic real interest rate on capital flows. [1]

2.2 State how capital inflows affect the demand for the currency. [1]

2.3 State the connection between the financial account and the current account. [1]

3 Exam-style questions

3.1 A higher domestic real interest rate attracts [1]

- A capital outflows
 - B capital inflows
 - C more imports
 - D lower saving
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3.2 Capital inflows _____ the demand for the domestic currency. [1]

- A raise
 - B lower
 - C do not change
 - D remove
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3.3 A country raises its real interest rate above the world rate.

(a) State the effect on capital flows. [1]

(b) State the effect on the demand for its currency. [1]

(c) State the effect on the exchange rate. [1]

4 Go further

- work through the **6.6 Real Interest Rates and International Capital Flows** lesson on the **Learn** page;
- read the **Open Economy** section of the AP Macroeconomics handout on the **Know** page.

Solutions

2.1 it attracts capital inflows.

2.2 it raises the demand for the currency.

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

3.1 B.

3.2 A.

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