Net Exports and Capital Flows

Introduction and Description

This lesson introduces net capital flows and examines their effect on the macroeconomy through the loanable funds market. The term *capital flow* refers to the movement of financial capital (money) between economies. Capital inflows consist of foreign funds moving into an economy from another country; capital outflows, or capital flight, is the opposite—domestic funds moving out of an economy to another country. The loanable funds market is used to analyze capital flows in an economy because financial capital affects the amount of money available for borrowers and shifts the supply curve for loanable funds.

In Activity 7-5, students analyze the effect of changes in the economy on net capital flows.

Objectives

1. Define capital inflow and outflow.
2. Graph and explain how changes in the current account and balance of trade affect the foreign exchange market.
3. Use a graph of the loanable funds market to analyze the effect of capital flows on the real interest rate.

Time Required

Two class periods or 90 minutes

Materials

Activity 7-5

Bell Ringer

Tell students to pretend they are visiting a foreign country and have arrived with only U.S. dollars. Ask them if they would want the dollar to appreciate or depreciate? Why?

Procedure

1. Explain the concepts of capital inflows and outflows. The term *capital flow* refers to the movement of financial capital (money) between economies. *Capital inflows* are foreign funds moving into an economy from another country. C*apital outflows* are the opposite—they are domestic funds moving out of an economy to another country. For example, from the perspective of the U.S. economy, the construction of a new plant by a Japanese automobile manufacturer within the United States is an example of capital inflow; when an American manufacturer finances the construction of a plant outside of the United States, it is an example of capital outflow.
2. Use a graph of the foreign exchange market to illustrate how changes in relative price levels, relative interest rates, fiscal and monetary policies, or direct foreign investment cause currencies to appreciate or depreciate.
3. Explain that the loanable funds market is used to analyze capital flows in an economy. Because financial capital affects the amount of money available for borrowers, changes in capital flows shift the supply curve for loanable funds. Capital inflows increase the supply of loanable

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funds, while capital outflows decrease the supply of loanable funds. When the supply of loanable funds changes, it changes the domestic real interest rate. Changes in the domestic real interest rate affect capital flows. Investors will move their financial capital into countries where the real interest rate is higher.

4. Point out that current account deficits are offset by financial account surpluses (capital inflow), while current account surpluses are offset by financial account deficits (capital outflow). If, for example, a current account deficit is not offset by the financial account surplus, people abroad will have more dollars than they desire. The value of the dollar will fall and as a result the current account deficit will become smaller (imports will decline as they are more expensive and exports will increase as they are less expensive). This will continue until the current account deficit is exactly offset by the financial account surplus.

5. Identify changes in net exports, changes in policy, and changes in foreign direct investment as causes of changes in capital flows.

6. Have students complete Activity 7-5.

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