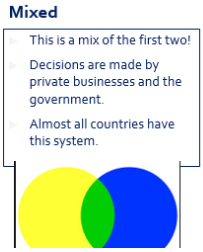


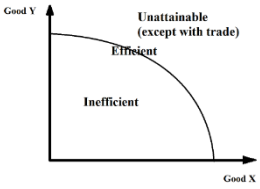
Unit 1

1.1 Scarcity

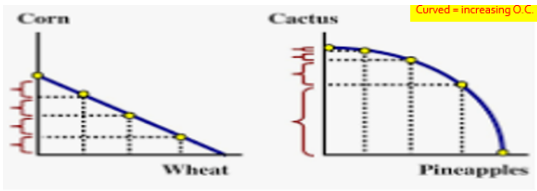
- Resources
  - What is scarcity
  - 4 types of resource: Land labor capital enterprise
  - Resources are used to satisfy our wants
- The fundamental economic problem — limited resources, unlimited wants
- Macroeconomics vs Microeconomics
- Market Economy, Planned Economy, Mixed Economy
  - Incentives
- Positive vs Normative economics — Positive = can be right or wrong eg. Dogs can fly = wrong. Dogs have 4 legs = right
  Normative = opinion that can't be proven right or wrong. eg. Dogs are amazing.

1.2 Opportunity Cost, PPC

- Opportunity cost definition — Next best opportunity foregone when we make a decision
- The PPC

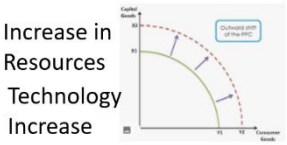


  - Graphical Representation
  - Tradeoffs / Opportunity Cost
  - Why only two goods?
  - Efficient, inefficient, unattainable
    - Pareto Improvement
    - Efficient in production vs efficient in allocation
  - Increasing vs constant opportunity cost



- Constant opportunity cost
  - Resources are equally suited for all production
    - EASILY ADAPTABLE
- Increasing opportunity cost
  - Resources are NOT equally suited for all production
    - NOT EASILY ADAPTABLE

- Shifting the PPC



1.3 Comparative Advantage and Gains from Trade

- Specialization and Adam Smith
- Absolute Advantage — Abs Adv: who can produce more
- Comparative Advantage (David Ricardo) — Compar Adv. = lower Opportunity Cost
- Gains from trade — Can consume outside of PPC, without changing the PPC at all.

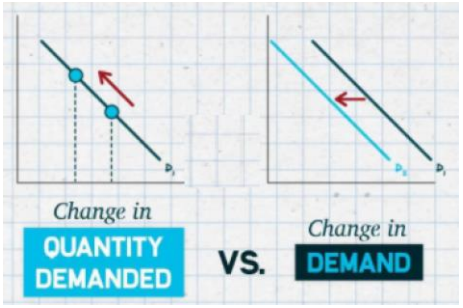
Adam Smith said that countries should specialize in what they have absolute advantage in.

David Ricardo said that they should really specialize in what they have comparative advantage in.

- How to do these questions
  - Output based — Output Based Questions: OC, Opportunity Cost = what you give up / what you gain = the 'other good' / the good you are looking at.
  - Input based — Input Based Questions: eg. labor hours, electricity used, resources used, capital used
- Terms of trade — Abs Adv: the smaller number
  Comp adv: Reverse the OC calculation

1.4 Demand

- Utility — The benefit that people receive from something. Higher Utility = You will pay a higher price (willingness to pay)
- What is a market — All buyers and sellers together.
- A demand schedule — Shows the relationship between price and quantity demanded by consumers.
- Law of Demand — Negative relationship between price and quantity.
- Three reasons for slope of demand — Income effect, substitution effect, diminishing marginal utility
- Two ways to look at demand



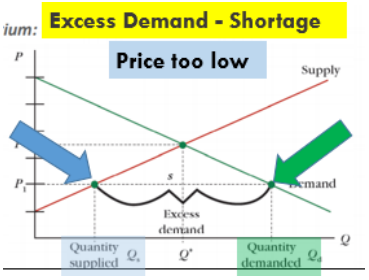
- Shifters/Determinants of demand

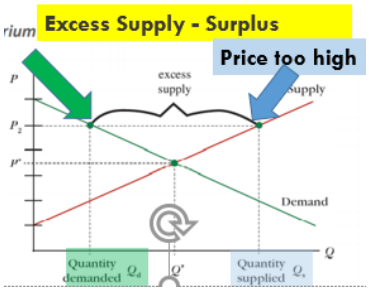
1.5 Supply

- Law of supply — Positive relationship between price and quantity.
- Two ways to look at supply
- Shifters/Determinants of supply

1.6 Market Equilibrium, Disequilibrium and Changes in Equilibrium

- Shortage/Surplus

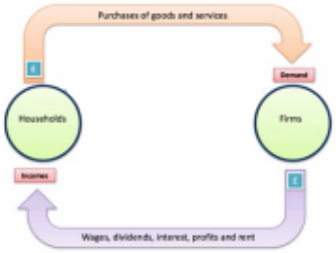




- Change in Equilibrium
- Double Shift Rule

Double Shift Rule: If both demand and supply shift, either price or quantity will be indeterminate.

Unit 2



2.1 Circular Flow and GDP

What is GDP? The total monetary value of everything produced in the economy in one year.

Circular flow

- Simple model
- More Complex Models
  - + government
  - + banks
  - + rest of world

Three ways of calculating GDP Expenditure Method (C+I+G+(X-M)) Value added method Income Method

2.2 Limitations of GDP

What is counted and not counted not: 2nd hand goods, Intermediate goods , Non-market activities

- Non-market transactions
- Environmental effects

2.7 Business Cycles

Recession, Expansion etc.

Recession: two or more quarters (6 months) of negative economic growth (fall in GDP).

Expansion: Economic activity increases and will finish by reaching the highest point called a peak.

2.3 Unemployment

Definition Unemployment rate = unemployed / labor force

Working age population, labor force, unemployed, employed

Limitations of Unemployment statistic

- Discouraged workers have left the labor force because they have lost hope.
- Underemployed workers have jobs but want to work more or in better jobs

Types of Unemployment

- Frictional people moving between jobs. This unavoidable and not a particularly negative thing because it is not considered long term.
- Structural
  - Technological Involves the loss of jobs due to technology.
  - Seasonal results from the change in demand due to seasonal factors.
- Cyclical – connected to the business cycle Increases in periods of economic contraction •Decreases in period of economic expansion

Natural Rate of Unemployment

= structural + frictional (when there is no cyclical unemployment)

Of working age – usually between 16 and 65

Labor force: People who are:Of working age – usually between 16 and 65; Willing – looking for a job; Able – capable of working

Unemployment Equations

Labor Force = employed + unemployed

Labor Force Participation Rate (LFPR)
= labor force / working age population
= (employed + unemployed) / Working age population

- **Unemployment Rate** = unemployed / labor force
- = unemployed / (employed + unemployed)

Unemployment Rate with more discouraged workers
= (Unemployed – X) / (Labor force – X)

Natural unemployment = Frictional unemployment + Structural unemployment
= (Frictionally unemployed + structurally unemployed) / labor force
IT IS NOT EQUAL TO ZERO

2.4 Price Indices and Inflation

What is inflation? price level (price of all goods and services) increases, value of money decreases

CPI Market Basket$_{new}$ / Market Basket$_{baseyear}$ x 100

Problems with CPI Changes to quality of goods (CPI overestimates inflation), Substituting for other goods (overstates), changes to basket (over/understates)

GDP Deflator

2.5 Costs of Inflation

Menu Costs, Shoe Leather Costs

Shoe Leather: Having to change money to other assets – time and effort

Menu: Having to change listed prices on menus, billboards etc.

Wages lose value, savings lose value, loss of unit of account

Unit of account – using money to measure the value of things

Borrowers gain, lenders lose

Fisher Equation: Real interest = Nominal interest - inflation

2.6 Real v. Nominal GDP

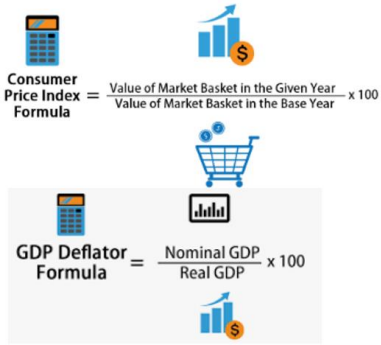
Real = adjusted for inflation

Real = Adjusted for Inflation, Old Prices x quantity

Nominal = not adjusted for inflation, New Prices x quantity

Equations Regarding Inflation

$$\text{Inflation} = \frac{\text{New} - \text{Old}}{\text{Old}} \times 100\%$$



$$\frac{\text{Real GDP in Year 2}}{\text{Nominal GDP in Year 2}} = \frac{\text{Price index of base year } (Y_1)}{\text{Price index in the current year } (Y_2)}$$

$$\text{Real GDP in Year 2} = \text{Nominal GDP in Year 2} \times \frac{\text{Price index of base year } (Y_1)}{\text{Price index in the current year } (Y_2)}$$

$$\text{Real GDP in Year 2} = \text{Nominal GDP in Year 2} \div \text{GDP Deflator} \times 100$$

Fisher Equation (Explains real interest rate and inflation, named after economist Robert Fisher):

Nominal Interest = Real Interest + Inflation

Eg. The bank charges 5% interest for its mortgages and the inflation rate is 2%. The real interest rate is 5-2=3%.

$$i \approx r + \pi$$

i = nominal interest
r = real interest
Π = inflation

Actual Inflation = Expected Inflation + Unexpected Inflation
(Unexpected Inflation – benefits borrowers, Unexpected deflation – benefits lenders)

Calculating GDP with Price and Quantity

NGDP = Prices$_{current}$ x Quantity$_{current}$

RGDP = Prices$_{base}$ x Quantity$_{current}$

Real Wage:

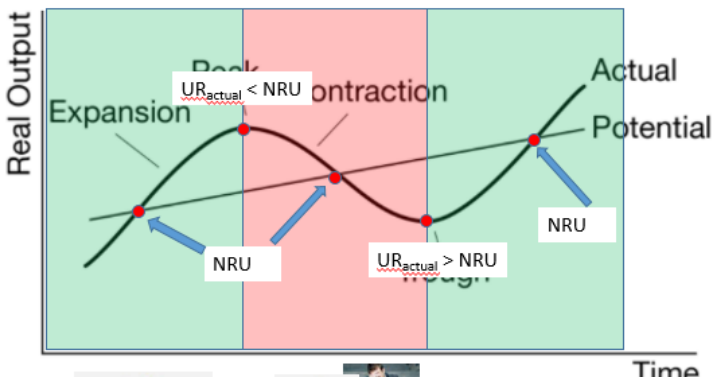
- Real Wages = Nominal Wages x PI$_{base}$ / PI$_{current}$
- Note: As an approximation one can use: %△ Real Wages = %△ Nominal Wages – Inflation, but this is only an approximation
- Eg. Your boss gives you a raise of 5% from last year and inflation is 3%. Your real wages have increased by 5-3=2% approximately.

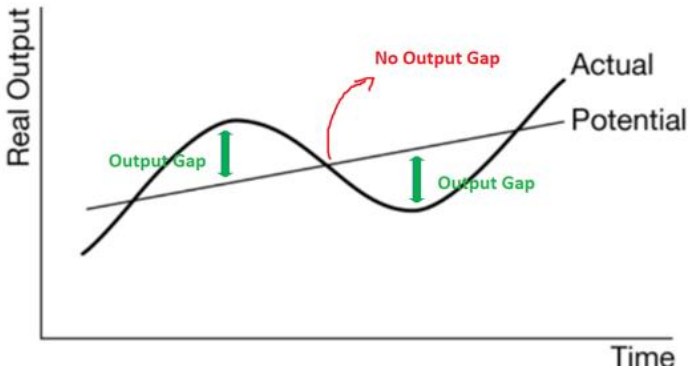
2.7 Business Cycles

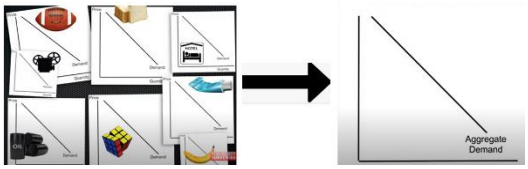
Recession, Expansion etc.

Output Gaps

Unemployment







Unit 3

3.1 Aggregate Demand (AD)

All market demand curves added together

Three reasons why it slopes down

1. Interest Rate Effect 2. Wealth Effect 3. Foreign Trade Effect

C+I+G+(X-M)

Axes are different: P → PL, Aggregate Price Level

Q → Real GDP, Real Output, Y

3.3 Short-Run Aggregate Supply (SRAS)

Shifters of SRAS / Short Run Supply Shocks

Sticky wages – causes upward slope

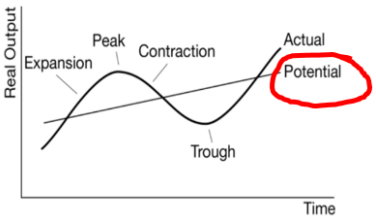
Sticky wages/resource costs – prices don't change because of contracts, mental resistance, efficiency wages

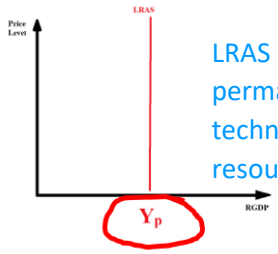
upward slope = +ve r'ship between PL and Output. Wages stay the same even when selling price of products changes, so profits/output increases/decreases

3.4 Long-Run Aggregate Supply (LRAS)

Shifters of LRAS / Long Run Supply Shocks

Connection to the Macroeconomy – PPC, Trend Line Growth





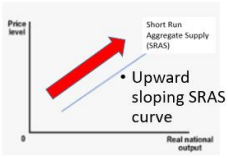
LRAS moves to right: permanent increase in technology or productivity or resources

Wage changes =

and

Price of product changes =

=



- Upward sloping SRAS curve

- Potential Output Y_P can be showed as the LRAS or on the business cycle.
- It represents the long run, sustainable level of output.
  - This level will increase as we have increases in technology, population, education etc.

3.5 Equilibrium in the Aggregate Demand–Aggregate Supply (AD–AS) Model

Long Run Macroeconomic Equilibrium AD=SRAS=LRAS

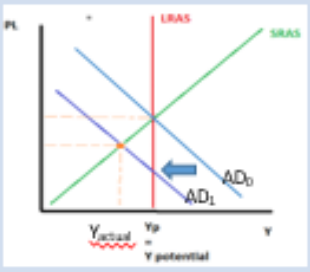
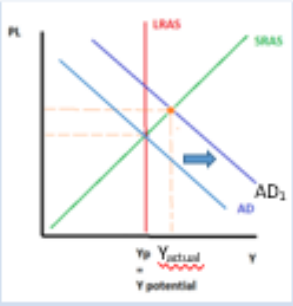
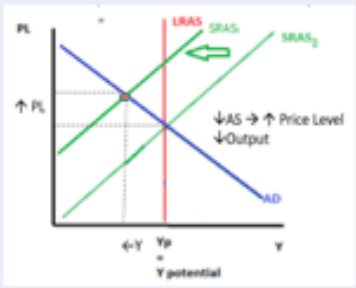
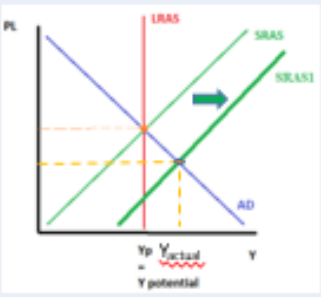
3.6 Changes in the AD–AS Model in the Short Run

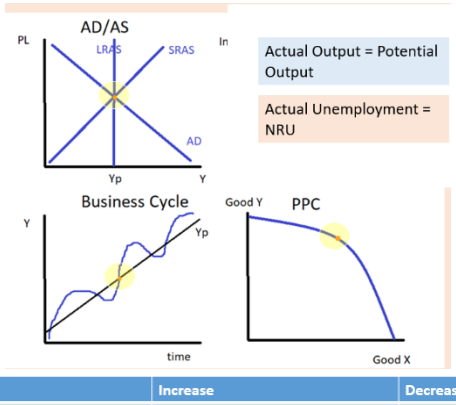
Short Run Macroeconomic Equilibrium AD=SRAS

Output Gaps

Negative – Recessionary Gap, Deflationary Gap, Stagflation (SRAS decreases)

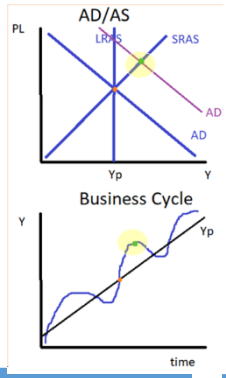
Positive – Inflationary Gap

	Decreases	Increases
AD	 **Negative Output Gap** / Recessionary Gap, sometimes called a Deflationary Gap This is the 'classic' recession situation.	 **Positive Output Gap** / Inflationary Gap While output is higher, there are concerns about inflation.
SRAS	 **Negative Output Gap** / Recessionary Gap **Stagflation** This is arguably the worst situation of all because we have low output and inflation.	 **Positive Output Gap** but NOT Inflationary Gap There isn't anything negative about this situation. Output is higher and inflation is under control.



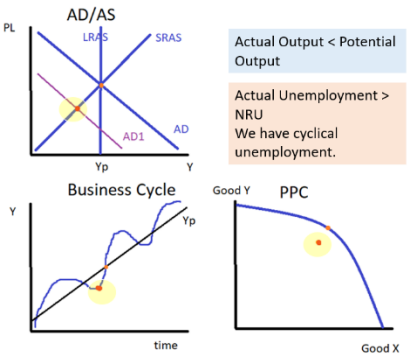
Actual Output = Potential Output

Actual Unemployment = NRU



Actual Output > Potential Output

Actual Unemployment < NRU



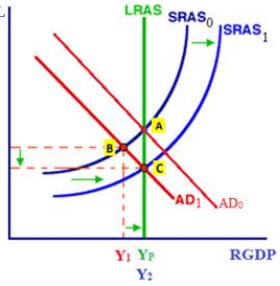
Actual Output < Potential Output

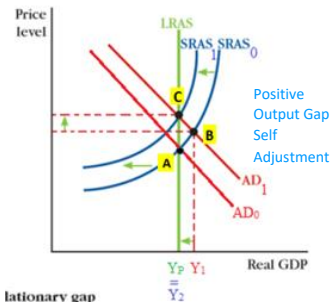
Actual Unemployment > NRU
We have cyclical unemployment.

Factor	Increase	Decrease
Stock market stocks owned by households	↑AD – consumers are wealthier now	↓AD – consumers are poorer now
Government purchases	↑AD – increase government spending	↓AD – decrease gov spending
Consumer Confidence	↑AD – consumers will buy more in the future	↓AD – consumers will buy less
Unemployment / Job Market Problems	↓AD – people have less income	↑AD – people have more income
Technology of Products	↑AD – consumers are attracted by new products	↓AD – consumers get less utility from products
Inventory levels and Capital Goods levels	↓AD – businesses don't need to invest as much in new inventory	↑AD – businesses need to buy a lot of new inventory

Factor	Increase	Decrease
Technology	↑LRAS, Y_P	↓LRAS, Y_P
Education of Workers	↑LRAS, Y_P	↓LRAS, Y_P
Number of machines	↑LRAS, Y_P	↓LRAS, Y_P
Population increase	↑LRAS, Y_P	↓LRAS, Y_P
Discovery of new resources	↑LRAS, Y_P	↓LRAS, Y_P
Climate Change	↓LRAS, Y_P	↑LRAS, Y_P
Long term change to corporate tax	↓LRAS, Y_P	↑LRAS, Y_P
Aging Population	↓LRAS, Y_P	↑LRAS, Y_P

Negative Output Gap Self Adjustment





Positive Output Gap Self Adjustment

lationary gap

Factor	Increase	Decrease
Commodity Cost	SRAS shifts to the left	SRAS shifts to the right
Nominal Wages	SRAS shifts to the left	SRAS shifts to the right
Productivity	SRAS shifts to the right	SRAS shifts to the left
Price of imported raw materials	SRAS shifts to the left	SRAS shifts to the right
Negative weather events (drought, earthquakes etc.)	SRAS shifts to the left	SRAS shifts to the right
Corporate Taxes	SRAS shifts to the left	SRAS shifts to the right
Education Levels	SRAS shifts to the right	SRAS shifts to the left
Inflationary Expectations	SRAS shifts left (workers ask for higher wages)	SRAS shifts right (business owners will lower people's wages)

3.7 Long-Run Self-Adjustment

Long Run Self Adjustment — SRAS Shifts due to resource costs becoming flexible in long run, to return economy to Y_P

Classical Economic Thinking vs Keynesian Thinking

Classical – economy self adjusts naturally

Keynesian – economy self adjusts but often takes too long so gov should intervene

3.8 Fiscal Policy (FP)

FP Tools
Gov spending
Gov transfers
Tax

Fiscal Policy – expansionary vs contractionary

Historical context: John Maynard Keynes

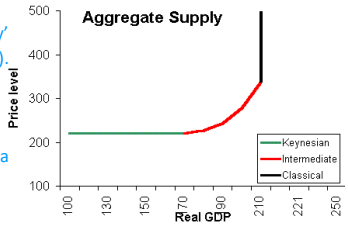
Fiscal Lag – Data Lags, Political Lags, Implementation Lags

Keynesian Aggregate Supply Curve

Expansionary – ↑AD, to fight a recession/negative output gap
↑Gov spending ↑Gov transfers ↓Tax

Contractionary - ↓AD, to fight inflation/positive output gap
↓Gov spending ↓Gov transfers ↑Tax

Horizontal section has 'space capacity' (unused resources). Keynes believed this shape meant Fiscal Policy could help the economy a lot when in a recession without causing inflation.

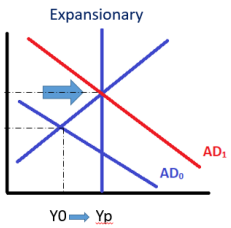


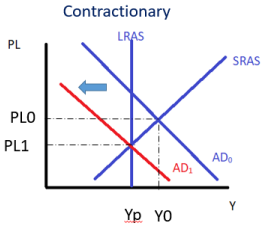
Fiscal Lag

Data lags – economic data takes time to collect and analyse, so information is not completely up to date

Political lags – political disagreement and decision making takes time

Implementation lags – fiscal spending projects such as building infrastructure, or military spending are not immediate



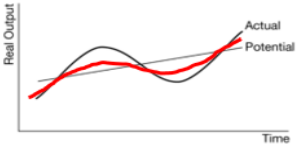


3.9 Automatic Stabilizers

Discretionary Fiscal Policy (human decision) vs. Non-discretionary fiscal policy (tax and social security)

Effect on the business cycle

The Automatic Stabilizers will 'smooth' the business cycle so that the recessions and expansions are less.



Two Types of Fiscal Policy

Discretionary Fiscal Policy/Automatic Stabilizers = tax, social security payments
Recession: ↓Tax ↑Social Security →↑AD
Inflationary Gap: ↑Tax ↓Social Security →↓AD
Reduces size of Output Gaps

Discretionary Fiscal Policy = human decisions are made to spend on things such as Infrastructure, Education, Military

3.2 Multipliers

MPC, MPS, Multiplier= 1/MPS = 1/(1-MPC)

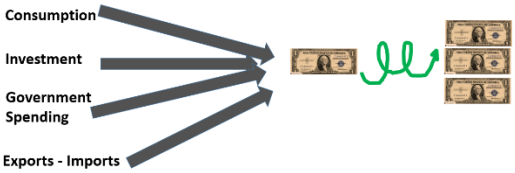
Tax Multiplier = -MPC/(1-MPC)

Transfer Multiplier = MPC/(1-MPC)

Full Multiplier: MPC + MPS + MPT (pay tax) + MPM (buy imports)

MPC = Marginal Propensity to Consume
MPS = Marginal Propensity to Save
MPS+MPC = 1

• All spending in the economy has a multiplier effect.

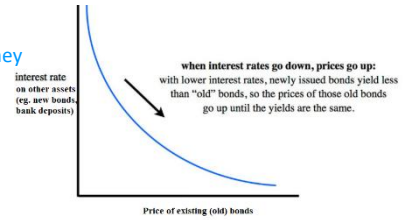


Spending Multiplier > Tax Multiplier
Therefore, equal size change to tax vs gov spending creates an ↑AD

Most important Equations for Multipliers:
ΔGDP = ΔSpending x Multiplier
ΔGDP = ΔTax x Tax Multiplier
ΔGDP = Δtransfers x transfer multiplier

Unit 4

When IR↑, existing bonds become less attractive (because people can put their money elsewhere and earn better interest) and so P_{bonds}↓



4.1 Financial Assets

Bonds — Debt asset – buyer of bond = lender. Paid back with interest.

Stocks/shares — Stocks = part ownership of company. Can receive share of profit but is not called interest.

Other financial assets — Mutual funds – you give money to professionals who invest it for you (eg.Pension fund)

Opportunity Cost of Holding Liquid Money — OC = The interest rate you could have earned on less liquid assets.

4.2 Nominal v. Real Interest Rates

Fisher Equation — Real Interest = Nominal Interest - Inflation

Unexpected inflation/deflation

Unexpected inflation – benefits borrowers

Unexpected deflation = benefits lenders

(With Fixed NIR. With Variable NIR, no one wins/loses.

4.3 Definition, Measurement, and Functions of Money

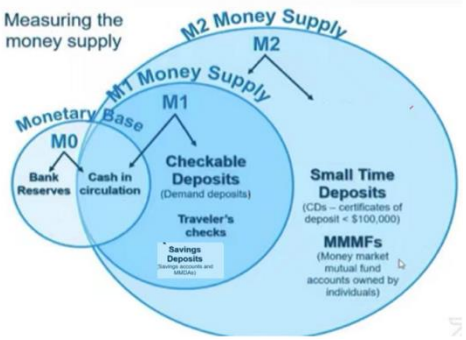
Definition of Money — Definition: Money is a medium of exchange that is universally accepted.

Money means that we do not have to barter (swap goods for other goods) because money is always accepted. Double coincidence of wants = you want what I have and I want what you have.

Barter Economy and Double Coincidence of Wants

Functions of Money — Functions of Money:
1. Medium of Exchange – to buy goods and services
2. Unit of Account – you can measure the value of things eg. A $1000 phone compared to a $100 phone
3. Store of value – you can save money to buy something in the future

M1 vs M2 Money — M1 – liquid money; M2 – less liquid money + M1



4.4 Banking and the Expansion of the Money Supply

The Federal Reserve — The Central Bank of the US, the Fed

Balance Sheets / T Accounts — Assets = things of value or will bring money in the future. Liabilities = things that will take away money in the future. Equity = Assets – Liabilities = total value of business.

Assets, Liabilities, Equity — Assets = Liabilities + Equity (but we often assume Equity = 0)

How to balance assets and liabilities

Money Multiplier = 1/RRR

ΔLoans = $Loan_{original}$ x 1/RRR

ΔDeposits = Deposit + $Loan_{original}$ x 1/RRR

Fractional Reserve Banking System — Banks keep part of their deposits as required reserves but can lend out the rest (which will increase the money supply)

Required Reserves, Excess Reserves — Excess Reserves – can be used to create new loans.

Banking System Money Multiplier

Buying Bonds, Selling Bonds

The Gov/Central Bank can buy/sell bonds to increase or decrease the MS. Buy Big, Sell Small

Why max ΔLoans and Money Supply may not occur:
1. Consumers hold extra cash
2. Banks keep excess reserves
3. Low demand for Loans

4.5 The Money Market

Holding Liquid Money

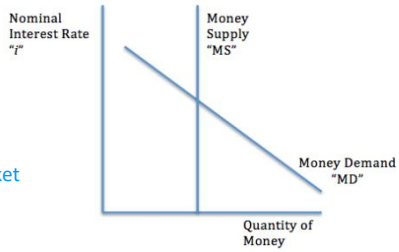
Money Market Demand — People desire liquid money for: Transactions, Asset, Precaution

Cost of holding liquid money — = interest that you gave up

Money market Supply

Nominal Interest Rates — Nominal interest because a short term market and future price level is not considered.

Effect of increase/decrease money supply

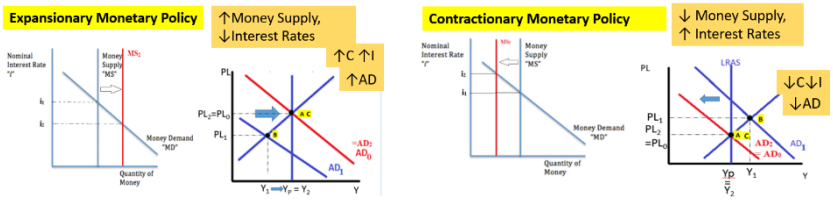


MD Shifters – price level, AD, Wealth, banking convenience

MS = Vertical – set by the Fed, No relation between interest and quantity

Increase MS = expansionary monetary policy

Decrease MS = contractionary monetary policy



4.6 Monetary Policy

Expansionary vs Contractionary

3 tools of monetary policy

Buy = big (increase MS)
Sell = small (decrease MS)

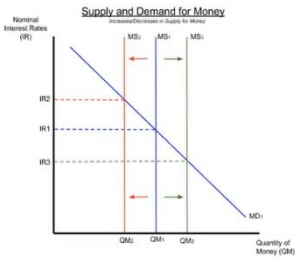
Open Market Operations (OMO)

Discount Rate/Federal Funds Rate

Required Reserves

Policies' Impact on Supply:

Policy Name	Changes in Policy	Impact on Money Supply
Discount Rate	Lower Discount Rate	MS_1 ↓ (MS_3) IR_1 ↑ (IR_3)
	Raise Discount Rate	MS_1 ↑ (MS_2) IR_1 ↓ (IR_2)
Reserve Ratio	Lower Reserve Ratio	MS_1 ↓ (MS_3) IR_1 ↑ (IR_3)
	Raise Reserve Ratio	MS_1 ↑ (MS_2) IR_1 ↓ (IR_2)
Open-Market Ops. (OMO)	Increase bond buying	MS_1 ↓ (MS_3) IR_1 ↑ (IR_3)
	Decrease Bond Buying (Increase Bond Selling)	MS_1 ↑ (MS_2) IR_1 ↓ (IR_2)



4.6 Ample Reserves Monetary Policy

Limited Reserves Economy

3 Tools of MP can be used

(OMO, RRR, Discount Rate)

Ample Reserves Economy

Conditions

Change of MS no longer affects the IR

Ample/Unlimited Reserves in Econom,

RRR is at zero

Monetary Policy

Fed can increase/decrease the administered rates

Discount Rate, Interest on Reserves

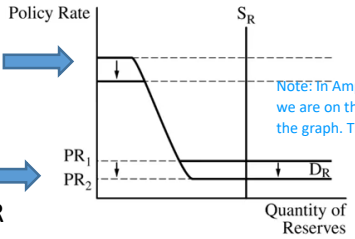
This affects the Policy Rate

Contractionary MP (increasing IR)

Decrease in Administered Interest Rates

Discount Rate (top flat part)

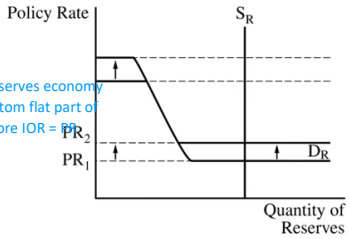
Interest on Reserves (bottom flat part) Usually IOR = PR



Note: In Ample reserves economy we are on the bottom flat part of the graph. Therefore IOR = PR

Expansionary MP (lowering IR)

Increase in Administered Interest Rates



Policy Rate (PR) – in the US, the Federal Funds Rate (FFR), the rate that banks pay when they lend to each other.

Discount Rate (DR) – rate that commercial banks pay to borrow from the Fed.

Interest on Reserves (IOR) – rate that the Fed pays to banks for keeping reserves.

4.7 The Loanable Funds Market

Borrowing and Lending

Loanable Funds Demand

Rate of Return/Return on Investment

Loanable Funds Supply

Supply of Loanable Funds = Public Savings + Private Savings + Foreign Lending

Real Interest Rates

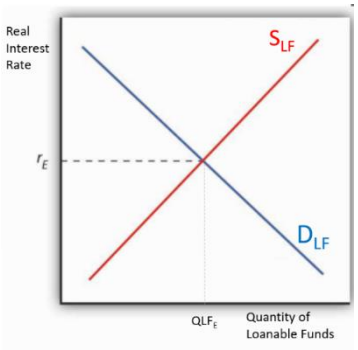
Real Interest Rate used because it is a long term market where inflation matters.

Government Budgets

Tax = Gov Expenditure — Balanced Budget

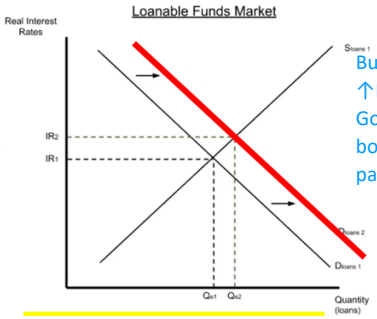
Tax < Gov Expenditure — Budget Surplus

Tax > Gov Expenditure — Budget Deficit



Supply of loanable funds = people wishing to lend and earn interest

Demand for loanable funds = people wishing to borrow



Budget Deficit → ↑D_{LF} because Government must borrow money to pay for expenditure.

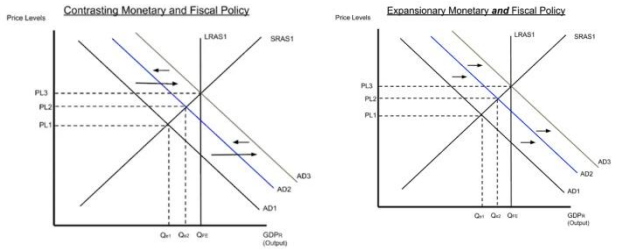
Factor	Effect on D_{LF}
Real Interest Rate	↑→Movement right on the same curve ↓→Movement left on the same curve
Rate of Return/Rate of Return	↑→↑D_{LF} (investment is more worthwhile) ↓→↓D_{LF}
Economic Confidence	↑→↑D_{LF} ↓→↓D_{LF}

Factor	Effect on S_{LF}
Real Interest Rate	↑→Movement right on the same curve ↓→Movement left on the same curve
Consumer Income	↑→↑S_{LF} (more money saved) ↓→↓S_{LF}
Performance in other markets (eg. Stock market, property market)	↑→↓S_{LF} (people will invest in other markets) ↓→↑S_{LF}

Unit 5

5.1 Fiscal and Monetary Policy Actions in the Short Run

FP and MP can move AD in the same direction or 'cancel each other out'



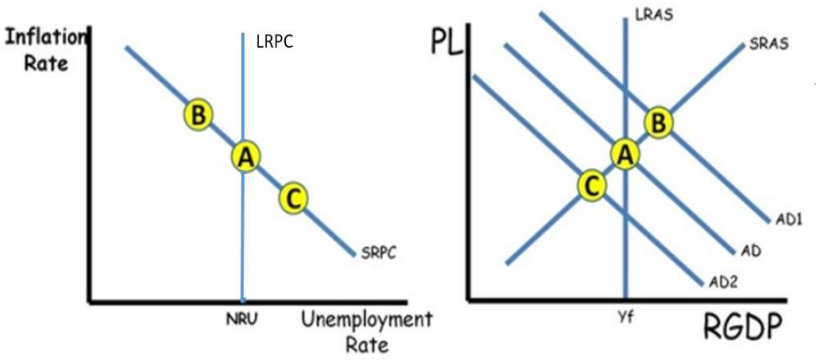
5.2 The Phillips Curve

Relationship between inflation and unemployment

SRPC

LRPC

Connection to other graphs

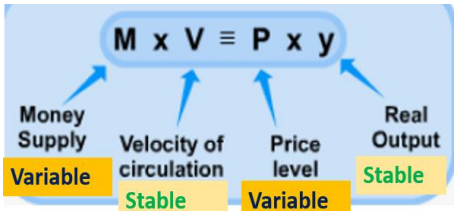


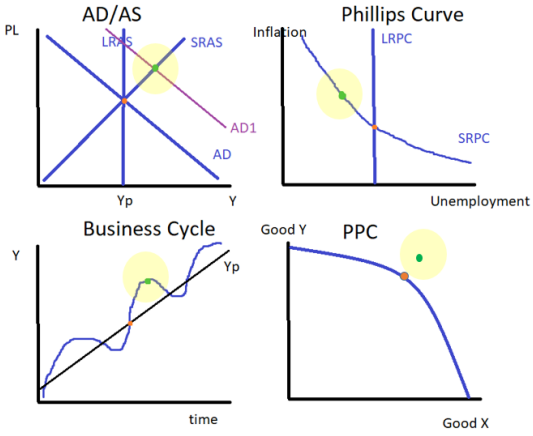
5.3 Money Growth and Inflation

Long Run

Money Neutrality

In the long run, increasing money supply has no effect on Output, Y
(However, in the short run expansionary MP can have an effect on Output, Y)





5.4 Government Deficits and the National Debt

Government Expenditure = Government Spending G + Government transfers (social security, unemployment benefits etc.)

Budget Deficits, Balanced Budget, Budget Surplus

Debt vs Deficit, Surplus vs Savings

Debt, Savings = over multiple periods of time
Deficit, Surplus = for one period, a year

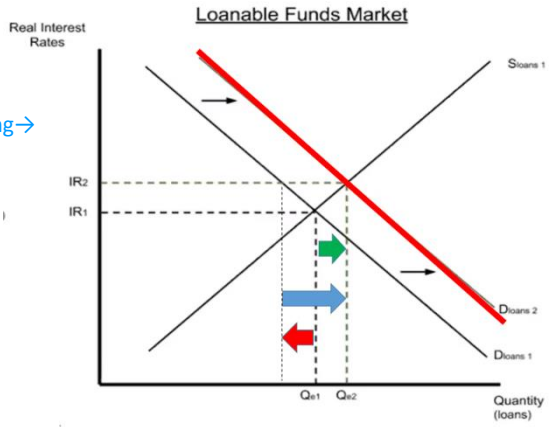
Balanced Budget: Tax = Government Expenditure →**Neutral Fiscal Policy**
Budget Deficit: Tax < Government Expenditure →**Expansionary Fiscal Policy**
Budget Surplus: Tax > Government Expenditure →**Contractionary Fiscal Policy**

5.5 Crowding Out

Effect of Government borrowing on private investment

Macroeconomic consequences

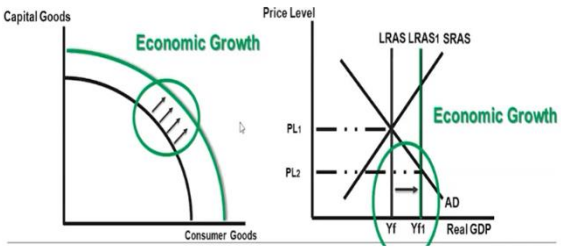
Expansionary FP / Budget deficit →↑Government borrowing→↑IR→↓Private borrowing→ →↓Investment→↓capital formation and technology→↓economic growth rate

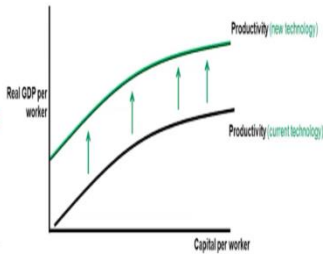


5.6 Economic Growth

Connecting all graphs that show economic Growth

PPC, AD/AS, Aggregate Production Function





Economic Growth ↑ Increase in Real GDP per capita

Determined by → **Productivity increases** → Determined by

- Capital stock formation
- Technology
- Human capital

5.7 Public Policy and Economic Growth

Supply Side Policies Policies and Fiscal Policies designed to shift LRAS to the right.

Lower income tax Gives businesses and people more of an incentive to work hard and earn profit, increasing supply

Less regulation Businesses have lower costs to start up and operate, increasing supply

Investment and encouraging investment

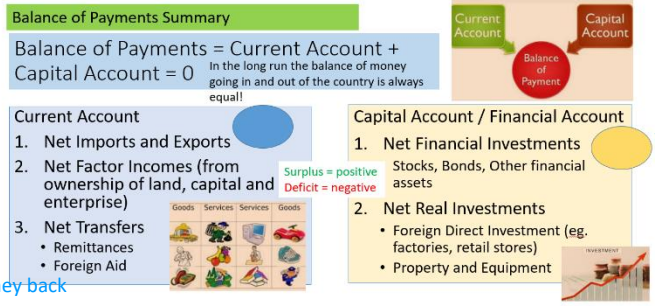
Capital
Technology
Human Capital

Increases the productivity of workers, leading to higher output per worker, increasing supply

Unit 6

6.1 Balance of Payments Accounts

The Balance of Payments



Foreign Direct Investment – companies investing in themselves in another country. Eg. Xiaomi opens a factory in Malaysia.

Remittances = sending money back home to family etc.

Credit vs Debit
Debit = Credit = money entering the country – Think: Extra credit
money leaving the country – Think: D = down

6.2 Exchange Rates

Exchange Rate – the value of Currency A in terms of Currency B. Eg. 1USD = 6.35 RMB, 0.15USD = 1 RMB

What is an exchange rate?

Appreciation – the value of the currency increases eg. 1USD = 1.3AUD → 1USD = 1.5AUD

Depreciation – the value of the currency decreases eg. 1USD = 1.5AUD → 1USD = 1.3AUD

Appreciation
= ↑Purchasing Power →↑Imports ↓Exports
Eg. Tourists travelling to other countries benefit.

Depreciation
= ↓Purchasing Power → ↓Imports ↑Exports
Eg. Exporters selling to foreigners benefit because their goods are cheaper.

Appreciation, Depreciation

Floating vs Fixed Exchange Rate Regimes

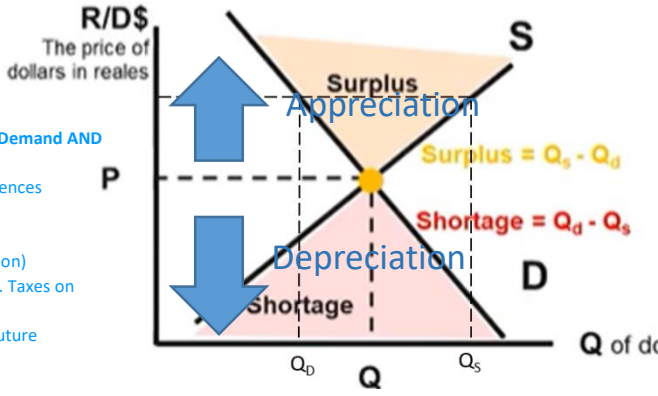
Floating Exchange Rate Regime – the demand and supply in the market determines the exchange rate and so it often goes up and down.

Fixed Exchange Rate Regime – the government wants to keep the exchange rate at a certain level and takes action to maintain this level.

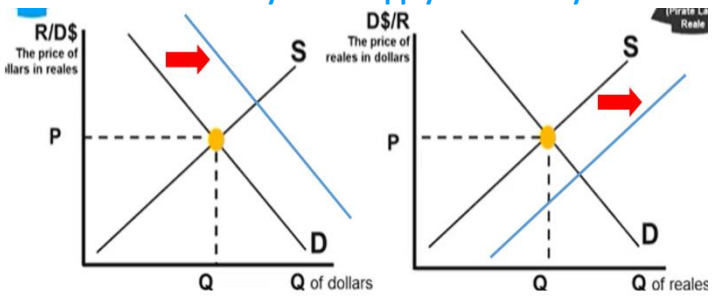
6.3 The Foreign Exchange Market

Exchange rate graph

Shifters of demand and supply of currency



ΔDemand of Currency A = Δ Supply of Currency B

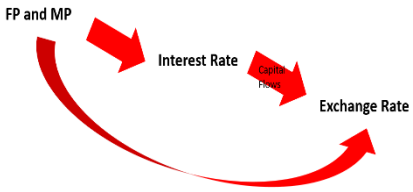


Determinants of Demand AND Supply
Tastes and Preferences
Income Level
Interest Rates
Price Level (Inflation)
Trade Policies (eg. Taxes on imports)
Expectations of Future Exchange Rate

6.4 Effect of Changes in Policies and Economic Conditions on the Foreign Exchange Market

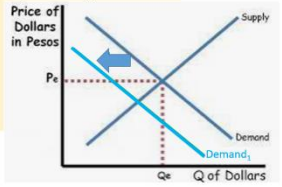
MP Effect on the Exchange Rate

FP Effect on the Exchange Rate



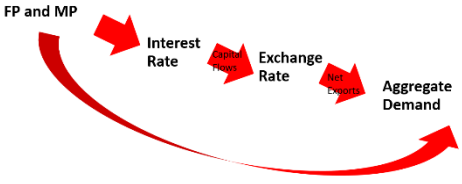
- **Expansionary fiscal policy**→↑Real Interest Rate (crowding out) →↑Capital Inflows→↑Exchange Rate

- **Expansionary MP** →↑MS→↓Interest Rate→↓Capital Flows→↓Demand for the currency →↓Exchange Rate



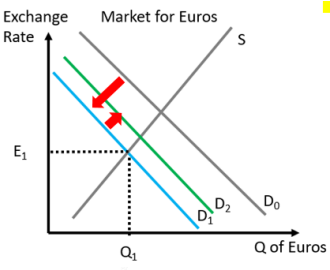
6.5 Changes in the Foreign Exchange Market and Net Exports

Effect of Exchange Rate on Net Exports and AD



↓Exchange Rate →↑X-M (imports more expensive for locals, exports cheaper for foreigners) →↑$D_{currency}$ →↑Exchange Rate?

In many of these questions we should remember that there are many variables affecting each other, however the 1st effect is stronger than the 2nd effect and so the movement in the original direction will still apply.



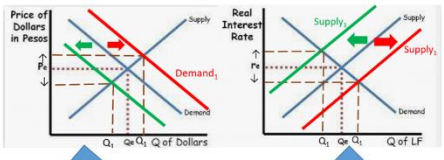
6.6 Real Interest Rates and International Capital Flows

Effect of Capital Inflows/Outflows on:

Net Exports and AD

Capital Formation

Two Consequences of Capital Inflows / Outflows



Consequence 1: Net Exports and AD
- Capital Inflows→↑Demand for currency →↑Exchange Rate →↓Net Exports →↓AD
- Capital Outflows→↓Demand for currency →↓Exchange Rate →↑Net Exports →↑AD

Consequence 2: Capital Formation
- Capital inflows→↑Supply Loanable Funds →↑Private borrowing and investment →↑Capital Formation
- Capital Outflows→↓Supply Loanable Funds →↓Private borrowing and investment →↓Capital Formation