International capital flows

- **Net capital outflows**
  = $S - I$
  = net outflow of "loanable funds"
  = net purchases of foreign assets
    the country's purchases of foreign assets
    minus foreign purchases of domestic assets
- When $S > I$, country is a net lender
- When $S < I$, country is a net borrower

Another important identity

$$NX = Y - (C + I + G)$$

implies

$$NX = (Y - C - G) - I$$

$$= S - I$$

trade balance = net capital outflows

Saving and Investment in a Small Open Economy

- An open-economy version of the loanable funds model from chapter 3.
- Includes many of the same elements:

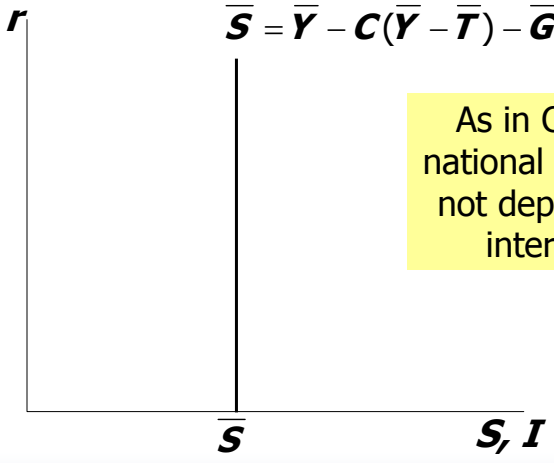
production function: $Y = \bar{Y} = F(\bar{K}, \bar{L})$

consumption function: $C = C(Y - T)$

investment function: $I = I(r)$

exogenous policy variables: $G = \bar{G}, \quad T = \bar{T}$

National Saving: The Supply of Loanable Funds



As in Chapter 3, national saving does not depend on the interest rate

Assumptions re: capital flows

a. domestic & foreign bonds are perfect substitutes (same risk, maturity, etc.)

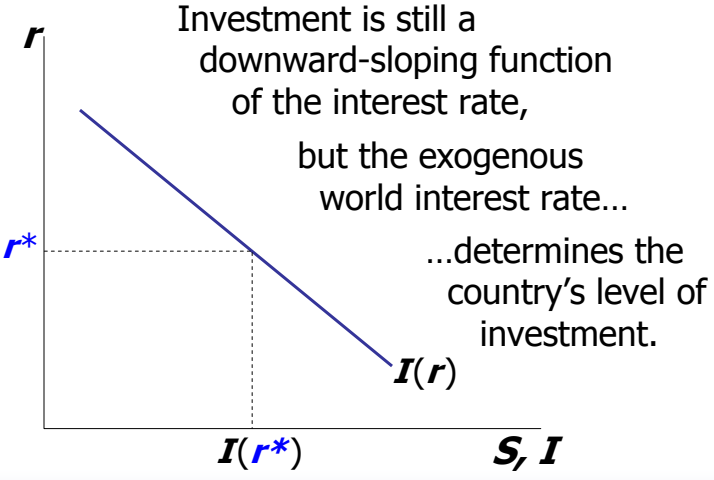
b. **perfect capital mobility**:
no restrictions on international trade in assets

c. economy is **small**:
cannot affect the world interest rate, denoted r^*

a & b imply $r = r^*$

c implies r^* is exogenous

Investment: The Demand for Loanable Funds



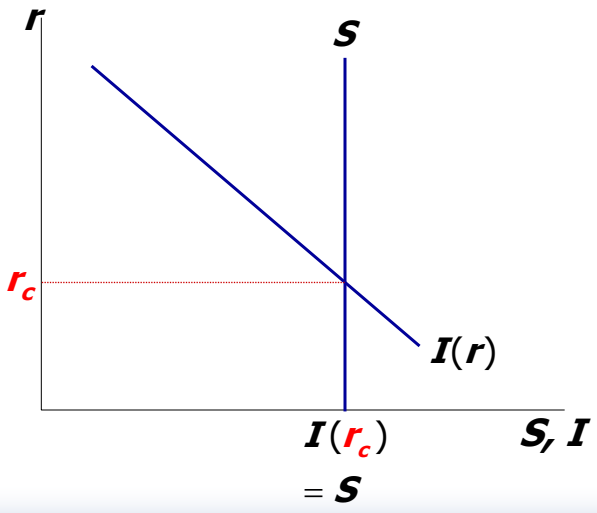
Investment is still a downward-sloping function of the interest rate,

but the exogenous world interest rate…

…determines the country's level of investment.

If the economy were closed…

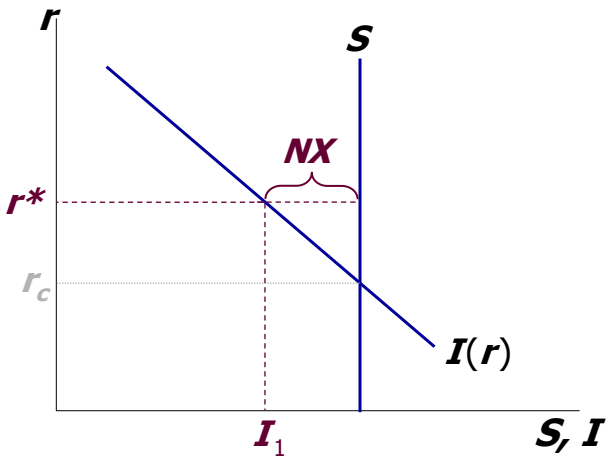
…the interest rate would adjust to equate investment and saving:



But in a small open economy…

the exogenous world interest rate determines investment…

…and the difference between saving and investment determines net capital outflows and net exports



Three experiments

1. Fiscal policy at home
2. Fiscal policy abroad
3. An increase in investment demand

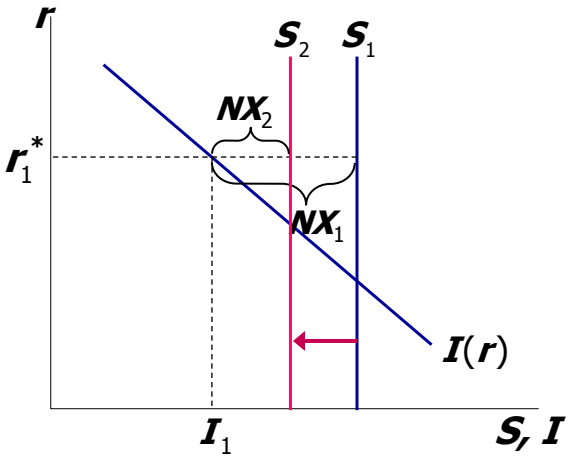
1. Fiscal policy at home

An increase in G or decrease in T reduces saving.

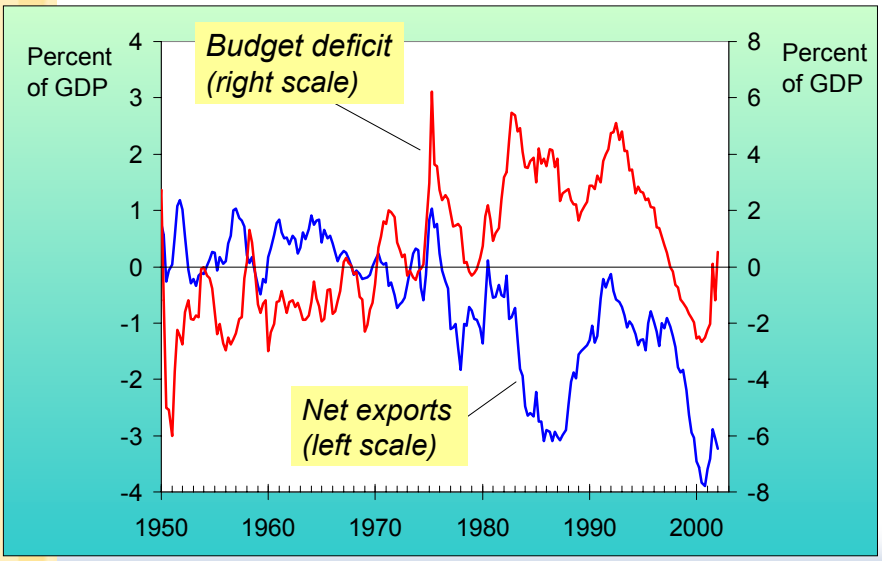
Results:

$\Delta I = 0$

$\Delta NX = \Delta S < 0$



NX and the Government Budget Deficit



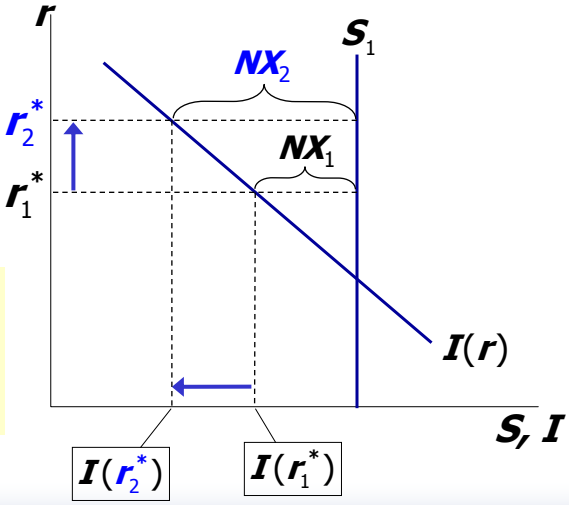
2. Fiscal policy abroad

Expansionary fiscal policy abroad raises the world interest rate.

Results:

$\Delta I < 0$

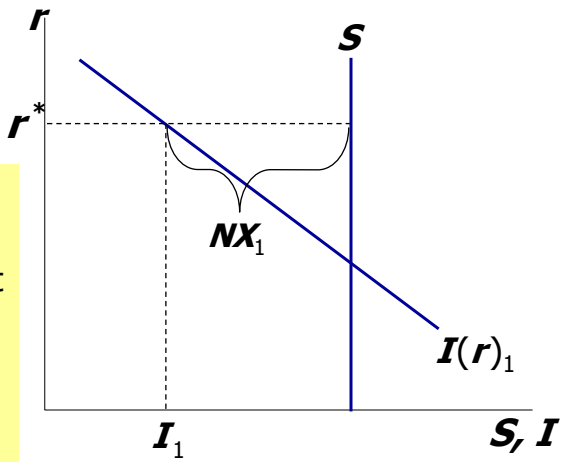
$\Delta NX = -\Delta I > 0$



3. An increase in investment demand

EXERCISE:

Use the model to determine the impact of an increase in investment demand on ***NX***, ***S***, ***I***, and net capital outflow.



3. An increase in investment demand

ANSWERS:

$\Delta I > 0$,

$\Delta S = 0$,

net capital outflows and net exports fall by the amount ΔI