The Fleming-Mundell Model

Agenda

• The Fleming-Mundell Model
  ➢ Fiscal and Monetary Policy with Perfect Capital Mobility

Capital Mobility

• The slope of the BP line indicates the degree of capital mobility in a country
  ➢ Horizontal: perfect capital mobility
    • Domestic R = World R
  ➢ Vertical: complete capital immobility
    • Domestic R completely independent of world R
  ➢ Upward sloping: partial capital mobility
    • Domestic R differs from the world R

Policy Analysis with Capital Mobility

• Policy Analysis with the BP Curve
  ➢ The intersection of the IS-LM curves establishes internal equilibrium.
  ➢ The BP curve establishes external equilibrium.
  ➢ If joint internal and external equilibrium does not exist, then either:
    • The currency must appreciate or depreciate, or
    • The central bank must intervene to stabilize the currency

Policy Analysis with Perfect Capital Mobility

• The Mundell-Fleming Model assumes a:
  ➢ Small open economy with
  ➢ Perfect capital mobility
    • The BP line is horizontal
Policy Analysis with Perfect Capital Mobility

- Expansionary fiscal policy, fixed exchange rates
  - IS curve shifts right, Y and R increase.
  - Higher R increases foreign capital inflow.
    - Creates BP surplus and upward pressure on currency.
  - Central bank intervenes in the foreign exchange market.
    - Buys excess foreign currency.
    - Increases foreign exchange reserves.
    - Sells domestic currency.
      - Increases the domestic money supply.
      - That is, non-sterilized intervention.
    - LM curve shifts right, Y increases, R decreases to its original level.
  - Result is much higher Y and constant R.

Expansionary Fiscal Policy, Fixed Exchange Rates

Y R BP IS0 LM0 Y0 R0 = R2 Y1 R1 LM2 Y1

Y R BP IS0 LM0 Y0 R0 Y1 Y2 Y

Policy Analysis with Perfect Capital Mobility

- Expansionary fiscal policy with fixed exchange rates is very powerful because it forces monetary policy to be fully accommodating.

Expansionary Fiscal Policy, Fixed Exchange Rates

Y R BP IS0 LM0 Y0 R0 = R2 Y1 R1 LM2 Y1

Y R BP IS0 LM0 Y0 R0 Y1 Y2 Y

Policy Analysis with Perfect Capital Mobility

- Expansionary monetary policy, fixed exchange rates
  - LM shifts right, Y increases and R decreases.
  - Lower R decreases foreign capital outflows.
    - Creates BP deficit and downward pressure on currency.
  - Central bank intervenes in the foreign exchange market.
    - Sells foreign exchange reserves.
    - Buys excess domestic currency.
      - Decreases the domestic money supply.
      - That is, non-sterilized intervention.
    - LM curve shifts left, Y decreases and R increases to its original level.
  - Result is same Y and R.
Expansionary Monetary Policy, Fixed Exchange Rates

**Policy Analysis with Perfect Capital Mobility**
- Expansionary monetary policy with fixed exchange rates is completely ineffective.

Expansionary Monetary Policy, Fixed Exchange Rates

**Policy Analysis with Perfect Capital Mobility**
- Expansionary fiscal policy, flexible exchange rates
  - IS curve shifts right, Y and R increase
  - Higher R increases foreign capital inflows.
    - Creates BP surplus and currency appreciates.
    - Stronger currency reduces net exports.
      - Lower exports, higher imports.
    - IS curve shifts left to its original position.
  - Result is same Y and R.

Expansionary Monetary Policy, Fixed Exchange Rates

Expansionary Fiscal Policy, Flexible Exchange Rates
**Expansionary Fiscal Policy, Flexible Exchange Rates**

- IS0 = IS2
- LM0 = LM2
- Y0 = Y2
- R0 = R2

**Policy Analysis with Perfect Capital Mobility**

- Expansionary monetary policy, flexible exchange rates
  - LM curve shifts right, Y increases and R decreases.
  - Lower R reduces foreign capital inflows.
    - Creates BP deficit and downward pressure on currency.
    - Currency depreciation stimulates net exports.
      - Higher exports, lower imports.
  - IS curve shifts right until R returns to its original level.
  - Result is much higher Y and constant R.

**Expansionary Monetary Policy, Flexible Exchange Rates**

- LM curve shifts right, Y increases and R decreases.
- Lower R reduces foreign capital inflows.
  - Creates BP deficit and downward pressure on currency.
  - Currency depreciation stimulates net exports.
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- IS curve shifts right until R returns to its original level.
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**Expansionary Fiscal Policy, Fixed Exchange Rates**

- Expansionary fiscal policy with flexible exchange rates is completely ineffective.
  - Exchange rate affects completely offset fiscal policy changes.

**Expansionary Monetary Policy, Fixed Exchange Rates**

- LM curve shifts right, Y increases and R decreases.
- Lower R reduces foreign capital inflows.
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Expansionary Monetary Policy, Flexible Exchange Rates

Policy Analysis with Perfect Capital Mobility

• Expansionary monetary policy with flexible exchange rates is very powerful because it forces net exports to be fully accommodating.
  ➢ Exchange rate affect compliments monetary policy adjustment.

Policy Analysis with Perfect Capital Mobility

• Summary of Policy Effectiveness

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<th>Fixed Exchange Rates</th>
<th>Flexible Exchange Rates</th>
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<td>Completely Ineffective</td>
<td>Extremely Effective</td>
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<tr>
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