Quadrant II – Notes

Paper Code: CEG 102

Module Name: Mundell – Fleming Model (IS-LM-BP) Model Part II

Module No: 24

Notes: Mundell – Fleming Model (IS-LM-BP) Model Part II

The IS-LM-BP model: In the model we distinguish between perfect and imperfect capital mobility, fixed and flexible exchange rates. For each of these cases, we see what happens when both an expansionary monetary and fiscal policy are applied to the economy.

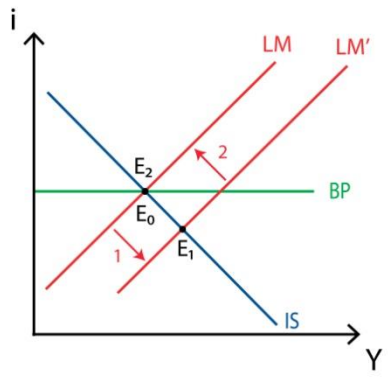
Key assumptions:

1. A small open economy with perfect capital mobility
2. Tax rates are the same everywhere
3. Foreign investors do not face political risk

The Mundell – Fleming model can be studied as under;

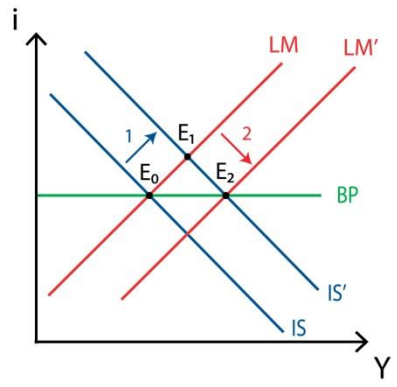
1. Impact of expansionary monetary policy under Fixed Exchange rate
2. Impact of expansionary fiscal policy under Fixed Exchange rate
3. Impact of expansionary monetary policy under Flexible Exchange rate
4. Impact of expansionary fiscal policy under Flexible Exchange rate

1. <u>Impact of expansionary monetary policy under Fixed Exchange rate</u>



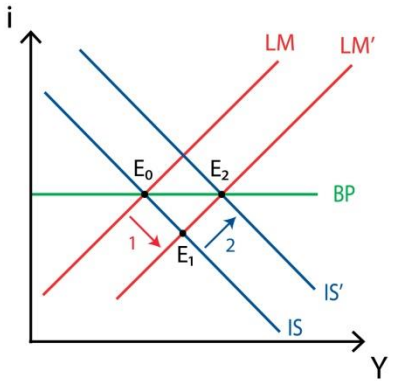
An expansionary monetary policy will shift the LM curve to LM', which makes the equilibrium go from point E_0 to E_1. However, since we are below the BP curve, we know the economy has a balance of payments deficit. Since exchange rates are fixed, government intervention is required: the government will purchase domestic currency and sell foreign currency, which will drop the money supply and therefore shift the LM' curve to its original position (which makes the equilibrium go to E_2). Monetary policy has therefore no effect under these circumstances.

2. **Impact of expansionary fiscal policy under Fixed Exchange rate**



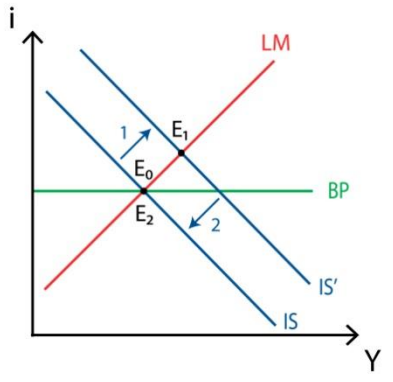
An expansionary fiscal policy will shift the IS curve to IS', moving the equilibrium form point E_0 to point E_1. Since the economy has now a balance of payments surplus, and because the exchange rate is fixed, government will intervene in the exact opposite way. They will purchase foreign currency and sell domestic currency. This will increase money supply, shifting the LM curve to the right. The final equilibrium is reached at point E_2 where, at the same interest rate, production has increased greatly: fiscal policy works perfectly under these circumstances.

3. **Impact of expansionary monetary policy under Flexible Exchange rate**



An expansionary monetary policy will shift the LM curve to LM', which makes the equilibrium go from point E_0 to E_1. However, since now exchange rates are flexible, we have a different situation: the balance of payments deficit will depreciate the domestic currency. This will increase net exports (since foreigners can now buy more of our products with the same amount of money), which will shift the IS curve to the right (to IS'). The final equilibrium is reached at point E_2 where, at the same interest rate, production has increased greatly: monetary policy works perfectly under these circumstances.

4. **Impact of expansionary fiscal policy under Flexible Exchange rate**



An expansionary fiscal policy will shift the IS curve to IS', moving the equilibrium from point E_0 to point E_1. The economy will therefore have a balance of payments surplus, which in this case of flexible exchange rate will appreciate the domestic currency. This will decrease net exports, since we are able to import more goods and services with less money, while foreigners will import less of our products because of our appreciated domestic currency. This drop in net exports will shift the IS'

curve back to its original position. Since now the final equilibrium E_2 corresponds to the initial equilibrium, we know fiscal policy is no good in this case.

To sum up, under perfect capital mobility, monetary policy will only work with flexible exchange rates, while fiscal policy will only work with fixed exchange rates.