Macroeconomic Theory

Spring 2015
TuTh 2:30–3:45PM
Section 102

Created by

Richard Schwinn, Ph.D.

Based on

Macroeconomics, Blanchard and Johnson [2011]

Mundell–Flemming Model I

The Mundell–Fleming I model makes an important and extreme assumption:

M–F Model I

The economy can borrow or lend unlimited amounts on world financial markets without affecting the world interest rate.

- Consequently, the model only applies to small economies and the interest rate is determined by the world interest rates. And therefore

$$i = i^*$$

  always holds.

- You will see that the economy's behavior depends entirely on the exchange rate regime (either fixed or floating) that they choose.

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Under Fixed Exchange Rates

- Fiscal policy is *powerful*.
- Monetary policy is *powerless*.
- Any attempt to expand the money supply is futile, because the money supply must adjust to ensure that the exchange rate stays at its announced level.

Under Flexible Exchange Rates

- Monetary policy is *powerful*.
- Fiscal policy is *powerless*.
- A fiscal expansion causes the currency to appreciate, reducing net exports and offsetting the usual expansionary impact on aggregate demand.

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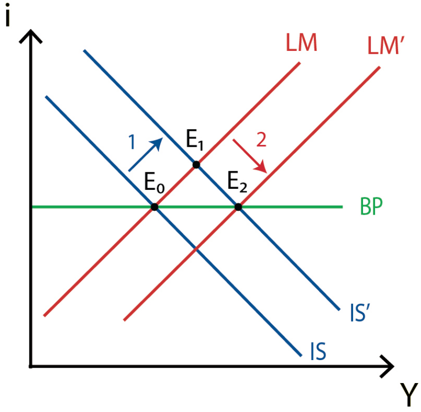
Fixed Rates, Fiscal Expansion

A fiscal expansion causes

- A rightward shift in the IS curve
- Which leads to an increase in the interest rate
- The marginally higher interest rate increases the demand for the domestic currency
- Thus forcing the monetary authority to expand the money supply
- This involuntary monetary expansion is required to hold the exchange rate constant and it returns i to i*



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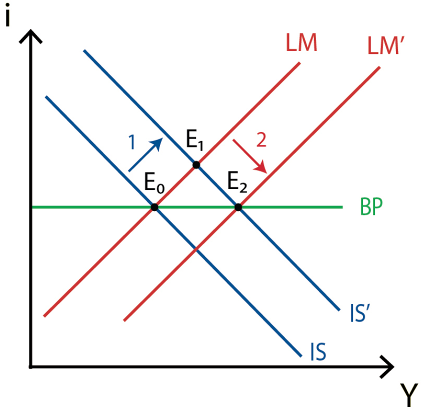

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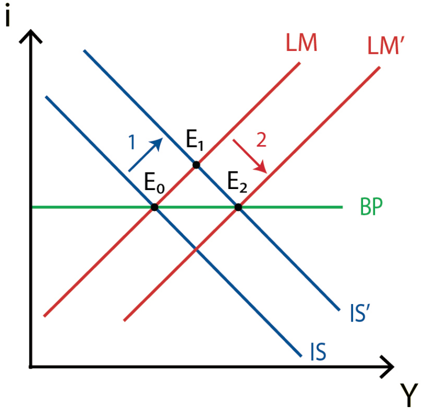

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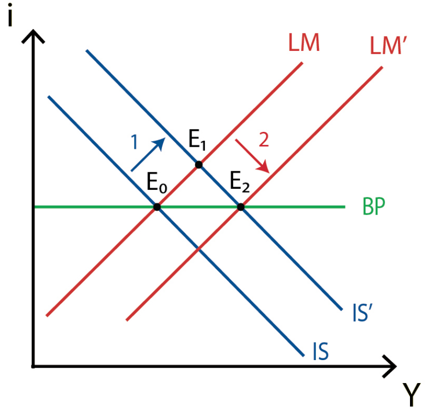

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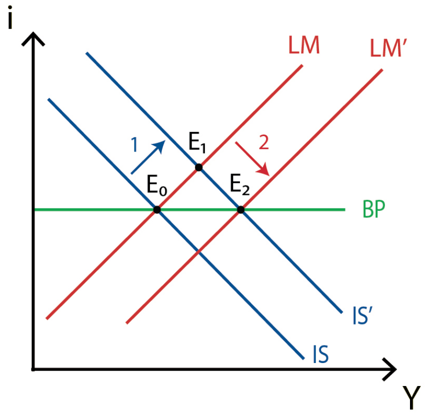

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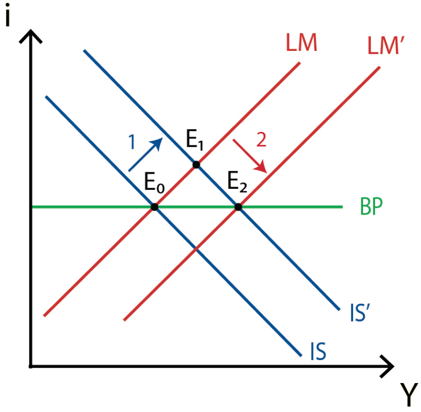
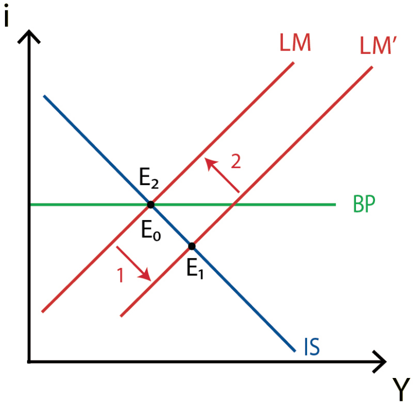


Fixed Rates, Monetary Expansion

A monetary expansion causes

- A decrease in the interest rate
- Decreasing the demand for the local currency
- Which, left unchecked, diminishes the exchange rate
- Forcing the monetary authority to decrease the money supply in order to return the exchange rate to its fixed level



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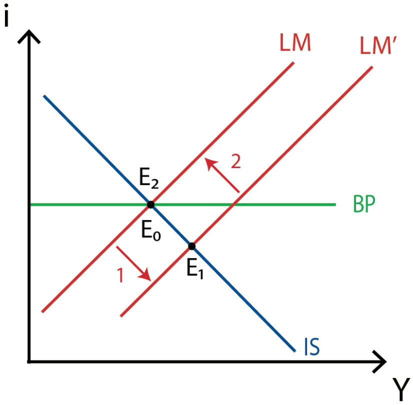

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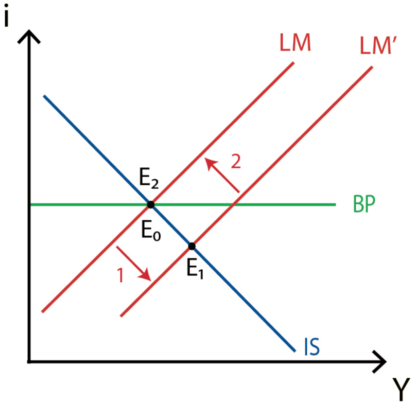

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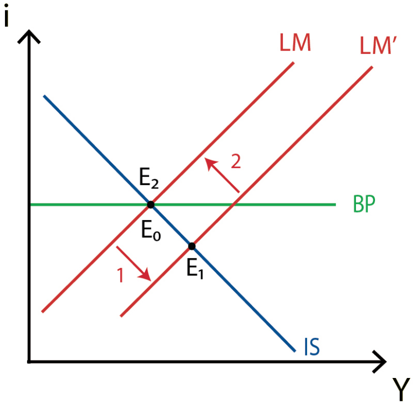

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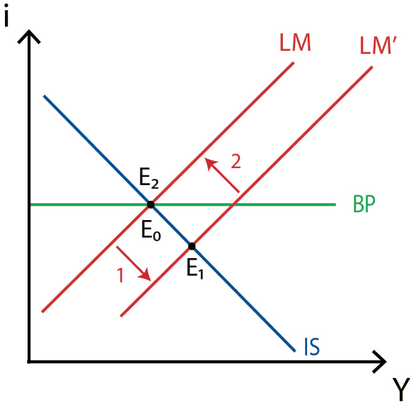
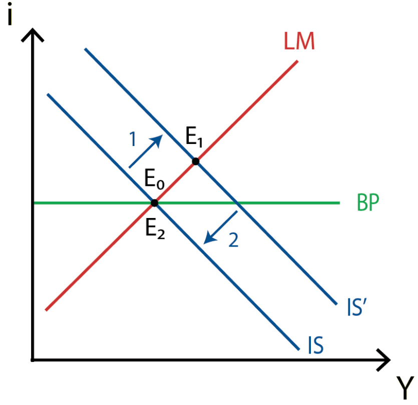


Flexible Rates, Fiscal Expansion

A fiscal expansion causes

- A rightward shift in the IS curve
- Which leads to an increase in the interest rate.
- The higher interest rates increases the demand for the domestic currency, in order to equalize i and i*
- Higher exchange rates reduce net exports
- This process continues until the IS curve returns to its starting position



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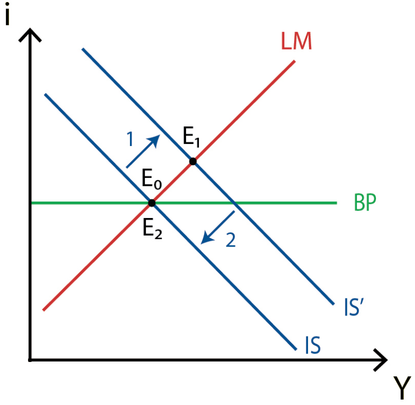

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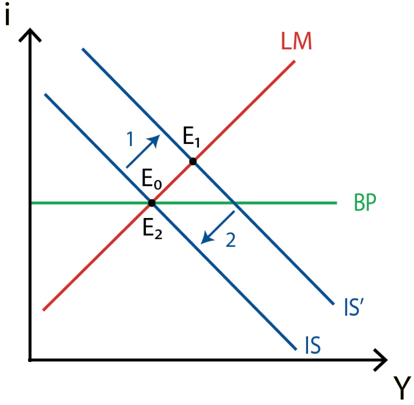

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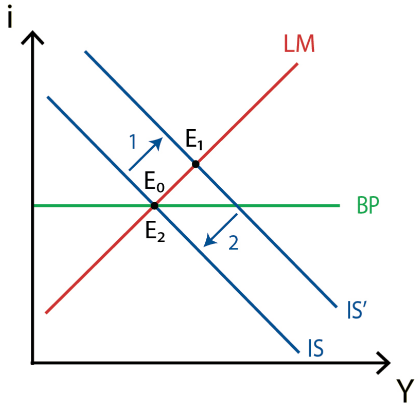

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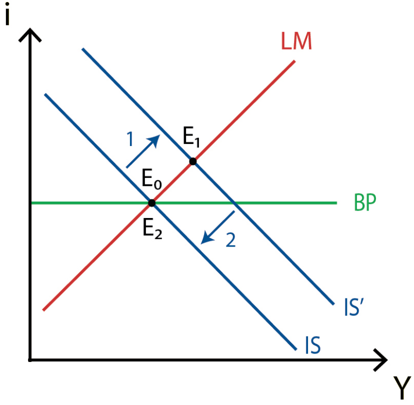

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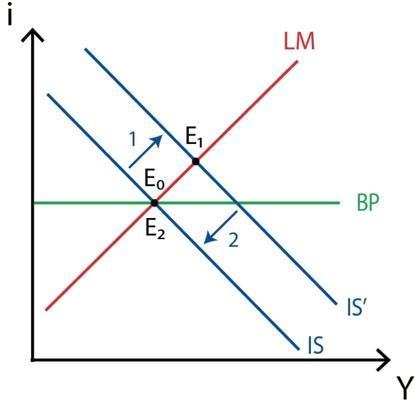

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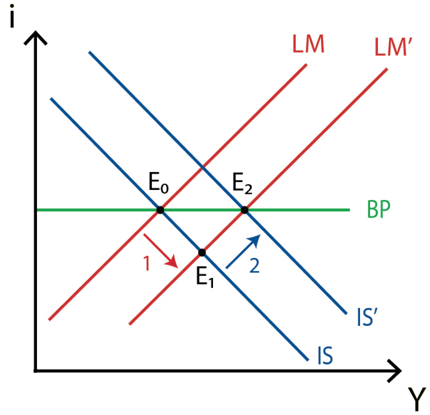

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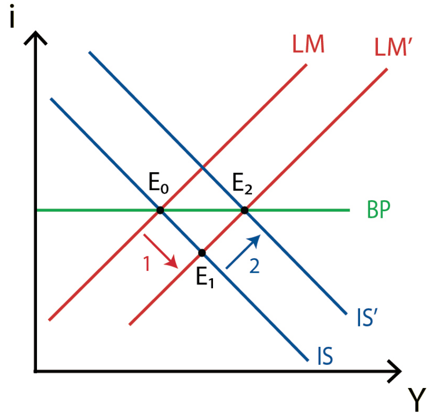

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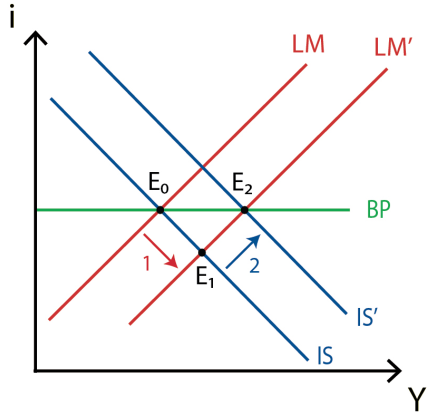

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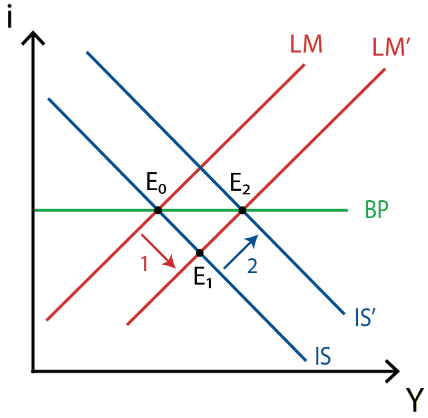

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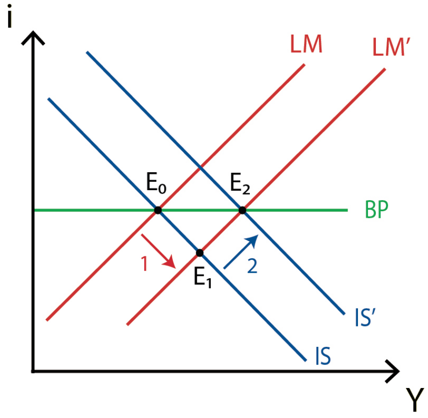

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Comments, questions, or concerns?

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Olivier Jean Blanchard and David Johnson. *Macroeconomics*. Prentice Hall, 6th edition, 2011. ISBN 9780133061635.