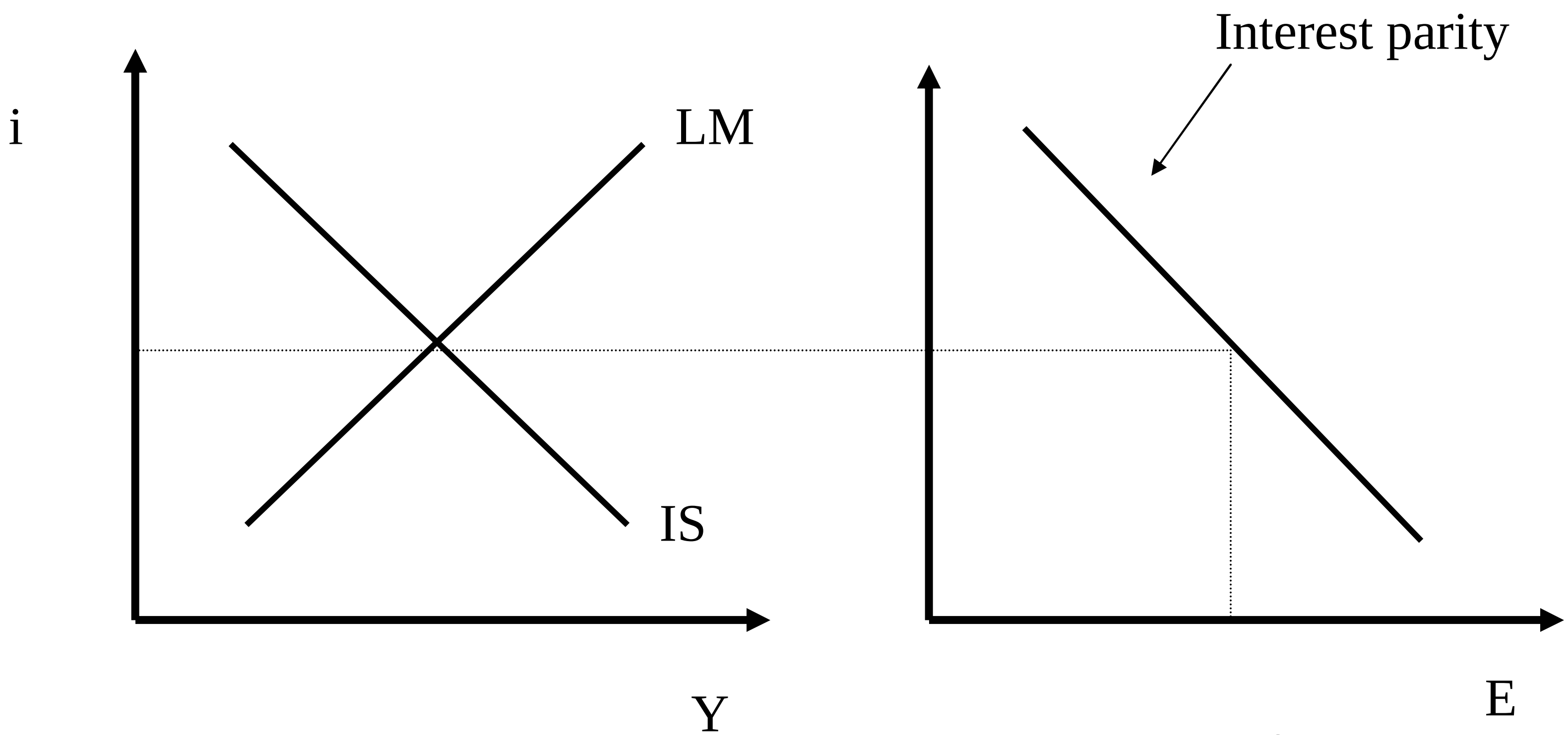
Lecture 11: Mundell-Fleming and Exchange Rate Systems

- Mundell-Fleming
- Fixed exchange rates
  - Policy
  - Crises
- Expectations

Mundell-Fleming

$$IS\ :\ Y = C(Y-T) + I(Y,i) + G + NX(Y, Y^*,\ E\ / (1+i-i^*))$$



$$\mathbf{E} = \frac{\mathbf{E}^{e}}{\mathbf{1+i-i^*}}$$

* Fiscal and Monetary policy

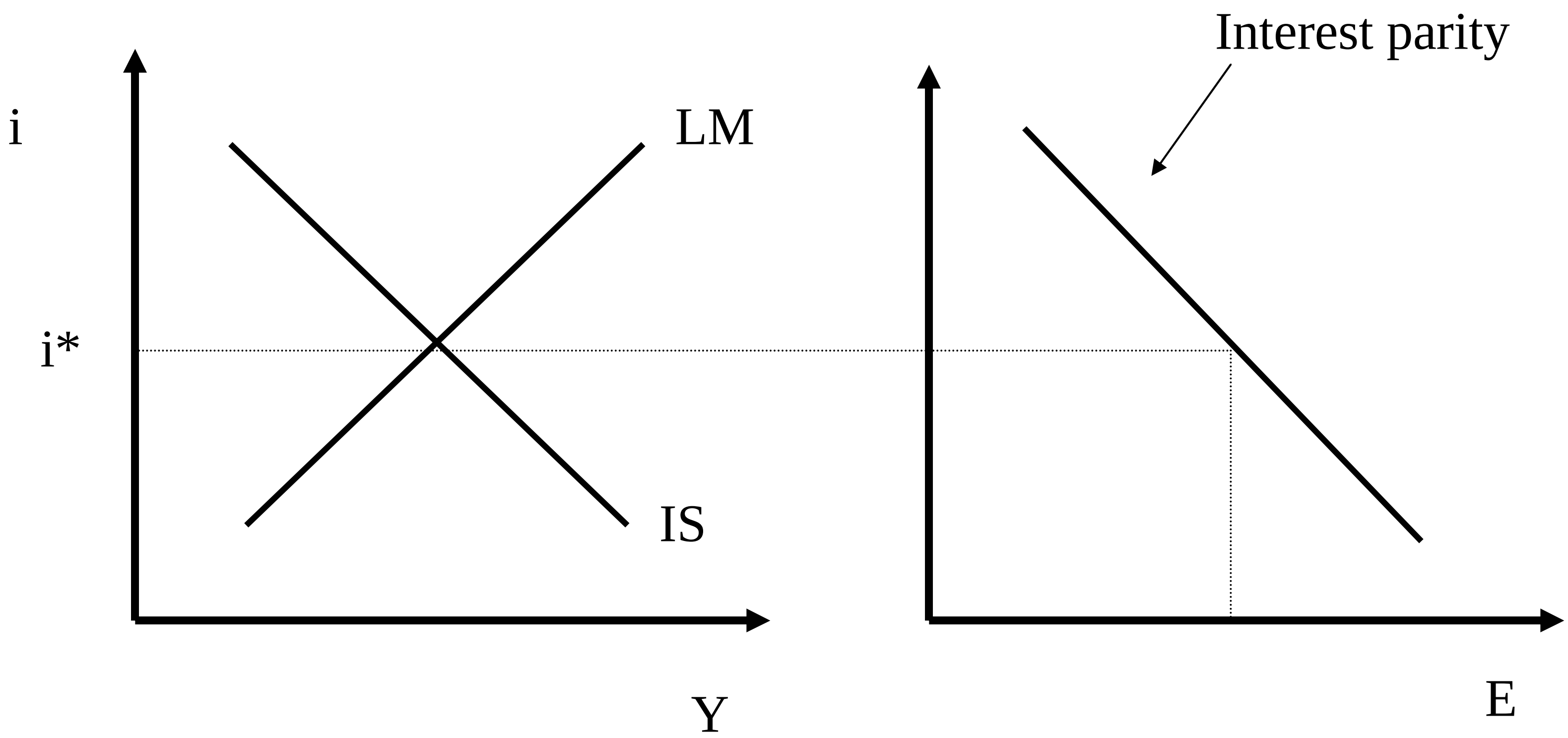
Fixed Exchange Rates (Credible)

- A little bit of it even in “flexible” exchange rates systems; “commitment” to E rather than M

=> $i = i^*$

=> $\frac{M}{P} = YL(i^*)$

- Central Bank gives up monetary policy



- Fiscal and Monetary policy
- Capital controls; imperfect capital flows

Crises in Fixed Exchange Rate Systems

$$i = i^* + (E^e(t+1) - E) / E$$

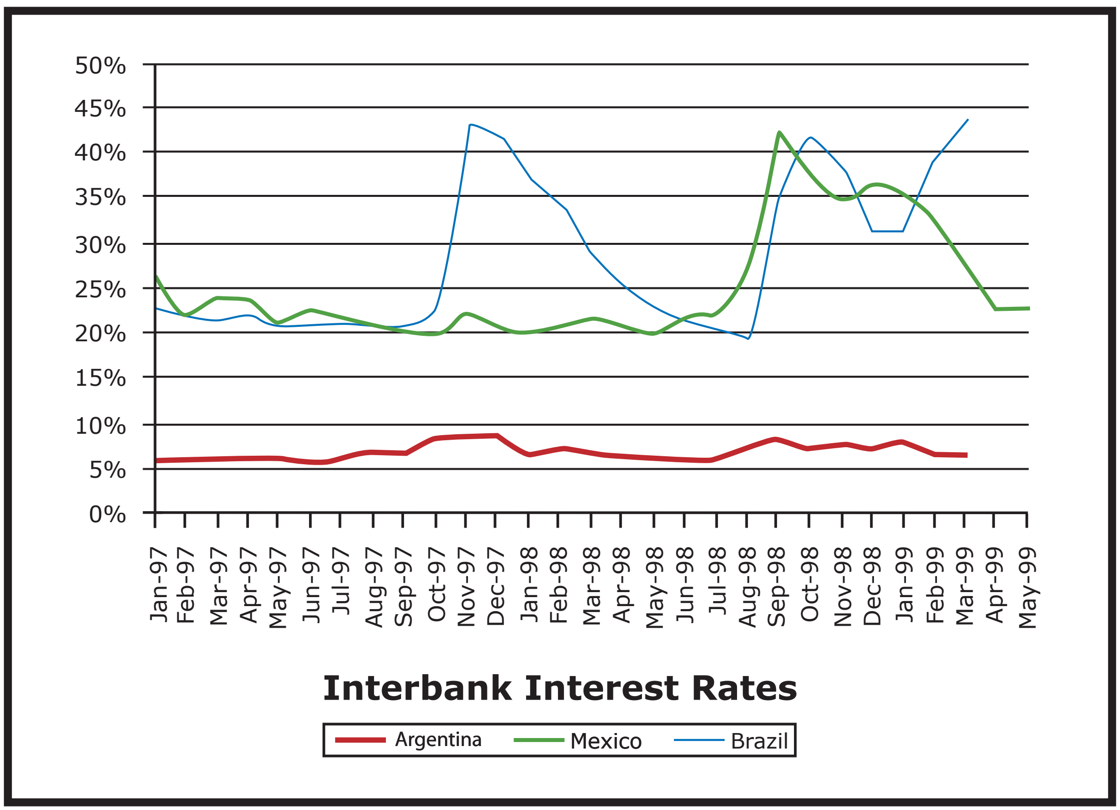
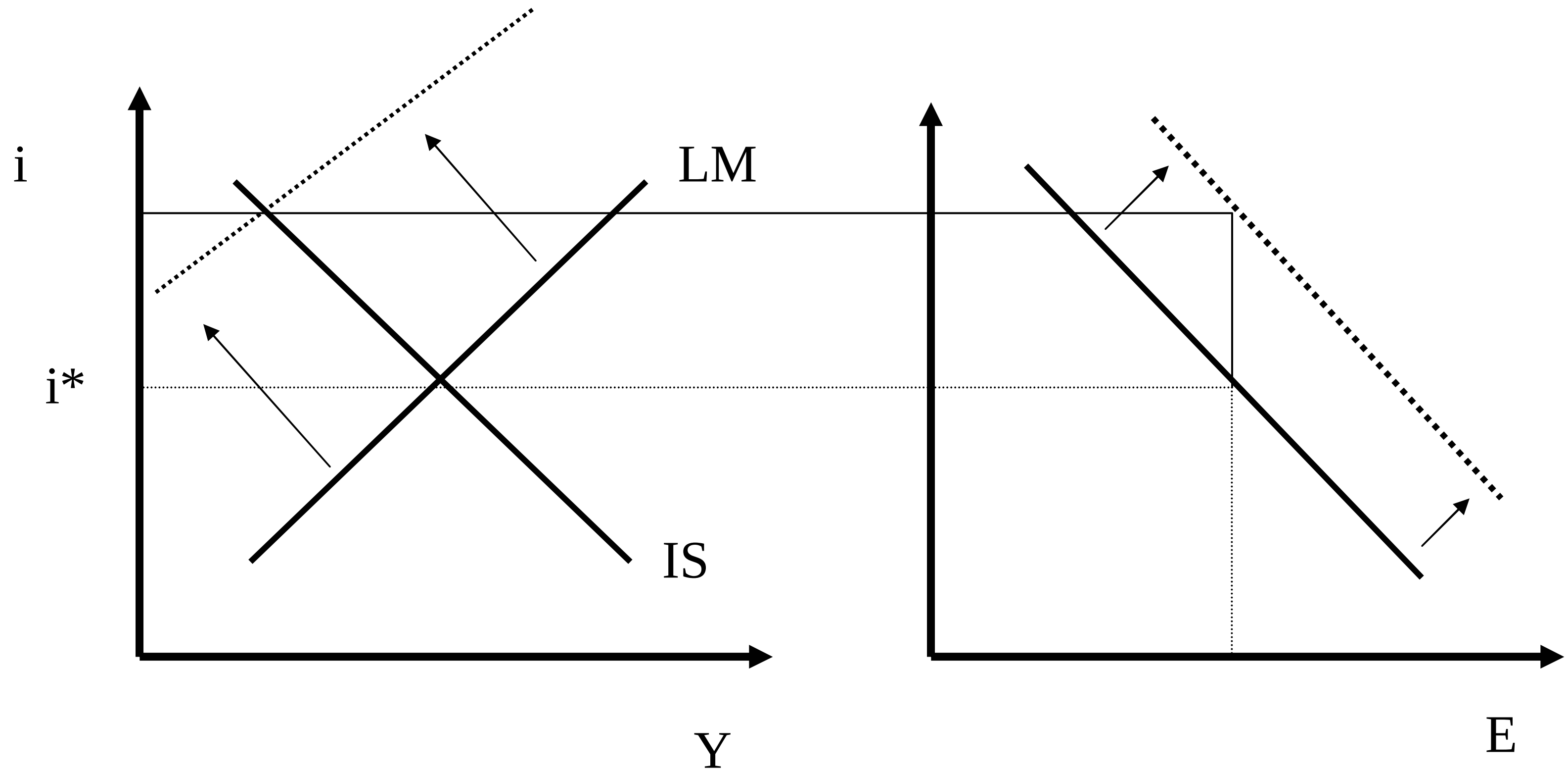


Figure by MIT OCW.

* ERM crisis: Sweden (500%)



Note: There is a shift in the IS as well… but this is small, especially in the short run

Expected Events

- Back to flexible exchange rates; expected M expansion