CLASS 10

TOPIC	***The Mundell-Fleming Model***	
LEARNING CONTENT - DETAILED CHARACTERISTICS	We consider the use of fiscal and monetary policy for stabilization purposes in an open economy whose effects depend on the degree of capital mobility and the type of exchange rate in existence. This is a fundamental model developed by Robert Mundell and Marcus Fleming at the start of the 1960s which is well-known and widely used until today. The goods market is presented by the IS curve that traces out a locus of combinations of interest rates and income associated with equilibrium in the goods market. The money market and the monetary policy conducted by the central bank is presented by the LM curve which traces out a locus of combinations of interest rates and income associated with equilibrium in the money market. The BP curve traces out a locus of combinations of domestic interest rates and income levels that yield an overall zero balance of payments position on the combined current and capital account. Using this framework, we observe different effects when fiscal and monetary policy change under fixed and flexible exchange rates and perfect and imperfect capital mobility. This helps us assess the effectiveness of fiscal and monetary policy considering financial stability issues. We study the international monetary trilemma which is based on the Mundell-Fleming model.	
KEY WORDS	The Mundell-Fleming model, IS curve, LM curve, BP curve, fiscal policy, monetary policy, Balance of payments, exchange rate regime, degree of capital mobility, international monetary trilemma.	
SUGGESTED TOOLS	Power-point presentation Critical thinking and analysis Real-world personal observation Interactive and group discussions A personal study plan	
TIPS / METHODOLOGICAL REMARKS (if applicable)	Learning-by-doing and case studies activities. The focus is on the framework of the Mundell-Fleming model and the effectiveness of fiscal and monetary policy under different assumptions and time perspectives.	
IMPLEMENTATION OF THE CLASSES	**STEP 1**	We make students aware of the goods and money market equilibrium conditions deriving the IS and the LM curve in an open economy. Different exchange rates are

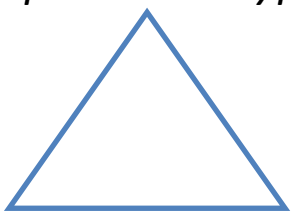
		considered so the effects of using fiscal and monetary policy are different.
	STEP 2	The BP curve is derived considering given levels of the world income, interest rate, price level, the exchange rate, and the domestic price level. The overall Balance of payments equilibrium is defined.
	STEP 3	We present the effects of a change in fiscal and monetary policy under a regime of fixed and flexible exchange rates and under perfect and imperfect capital mobility. Conclusions about the specificities of policy mix are drawn.
	STEP 4	The international monetary trilemma is presented so students are aware that it is impossible to have at the same time free capital mobility, a fixed exchange rate, and monetary policy independence. See work card 1.
	STEP 5	We discuss the effectiveness of fiscal and monetary policy under different assumptions and time perspectives. Policy recommendations and conclusions are drawn. See work card 2.

ADITIONAL MATERIAL 1 (WORK CARD, PICTURE, RECORDING, QUIZZ, PRESENTATION, ASSIGNEMENTS)

WORK CARD 1 – THE MUNDELL-FLEMING MODEL

Look at the international monetary trilemma below:

Independent monetary policy



fixed exchange rate ***perfect capital mobility***

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In your opinion, why does China apply Option I (independent monetary policy under a fixed exchange rate), the USA – Option II (independent monetary policy under perfect capital mobility) and Hong Kong Option III (perfect capital mobility under a fixed exchange rate). What about your country?

ADITIONAL MATERIAL 2 (WORK CARD, PICTURE, RECORDING, QUIZZ, PRESENTATION, ASSIGNEMENTS)

WORK CARD 2 – THE MUNDELL-FLEMING MODEL

Consider the following table that summarizes the effects of the interplay between fiscal and monetary policy under fixed and flexible exchange rates with perfect and imperfect capital mobility:

Exchange rate regime/capital mobility	Fixed exchange rate		Flexible exchange rate	
	Perfect capital mobility	Imperfect capital mobility	Perfect capital mobility	Imperfect capital mobility
• **Income effects**				
Monetary expansion	$\Delta Y = 0$ $\Delta R = 0$	$\Delta Y = 0$ $\Delta R = 0$	$\uparrow Y$ $\Delta R = 0$	$\uparrow Y$ $\uparrow R$
Fiscal expansion	$\uparrow Y$ $\Delta R = 0$	$\uparrow Y$ $\uparrow R$	$\Delta Y = 0$ $\Delta R = 0$	$\uparrow Y$ $\uparrow R$
Fiscal and monetary expansion	$\uparrow Y$ $\Delta R = 0$	$\uparrow Y$ $\uparrow R$	$\uparrow Y$ $\Delta R = 0$	$\uparrow Y$ $\Delta R = 0$
Higher foreign interest rate	$\downarrow Y$ $\uparrow R$	$\downarrow Y$ $\uparrow R$	$\uparrow Y$ $\uparrow R$	$\uparrow Y$ $\uparrow R$
• **Monetary policy instruments**				
Exogenous	Exchange rate	Exchange rate	M^S	M^S
Endogenous	M^S	M^S	Exchange rate	Exchange rate
• **Fiscal policy instrument**	G	G	G	G

What conclusions may you draw about fiscal and monetary policy options? How do the exchange rate regime and the degree of capital mobility affect income effects? What determines if fiscal and monetary policy instruments are endogenous or exogenous?

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