Lecture 11: Mundell-Fleming and Exchange Rate Systems

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

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

Interest parity

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

* 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

\[ i = i^* + \frac{(E(t+1) - E)}{E} \]

* ERM crisis: Sweden (500%)

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