GBO Semester II Year: 2019-2020

Paper Code: 2.1 Paper Title: Global Business Environment

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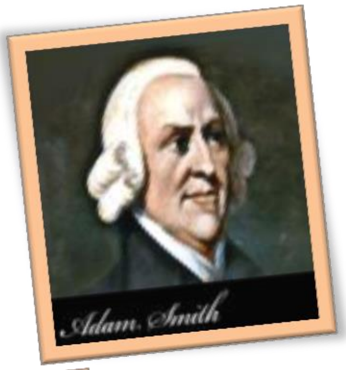
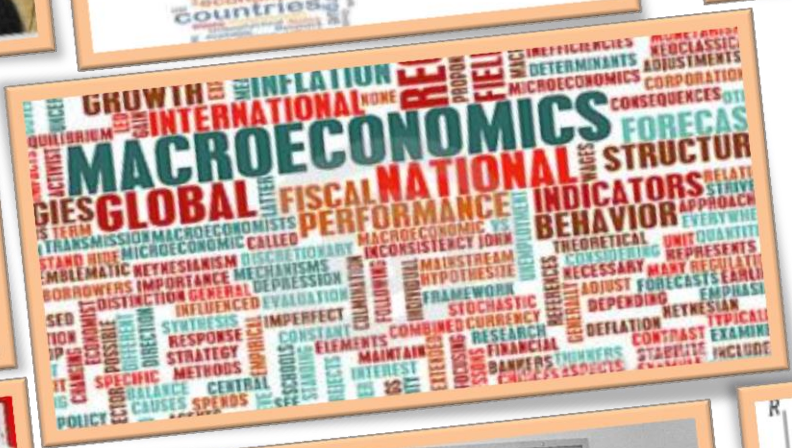
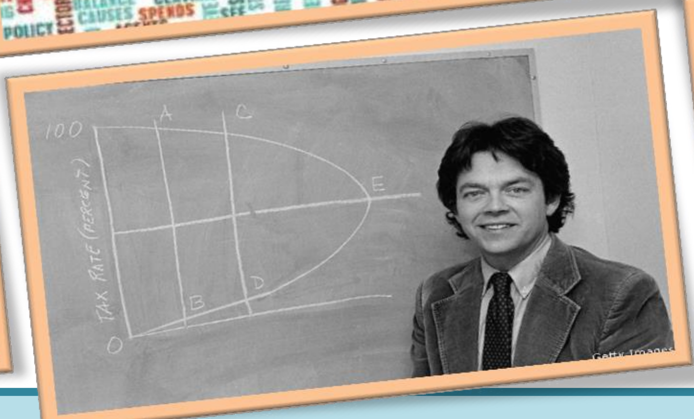
ECONOMICS

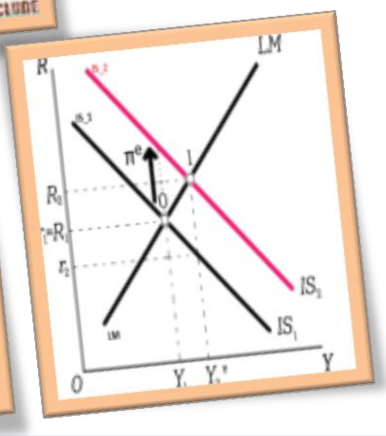
GLOBAL BUSINESS ENVIRONMENT

Online Lecture 5









THE IS-LM FRAMEWORK

MONETARY POLICY AND CONCLUDING REMARKS

International Linkages

(Reference: Rudiger Dornbusch and Stanley Fischer, Macroeconomics)

Important Terminology and Points to Remember

- The Balance of Payments
- Exchange rates: Fixed, Flexible and Managed/Dirty Float
- Goods Market Equilibrium: IS Curve is now also impacted by NX (Y, Y_f, R)
- Currency Appreciation shifts IS to the left
- Currency Depreciation shifts IS to the Right
- Capital Mobility: Balance of Payment and Perfect Capital Mobility
- Mundell-Fleming Model: Perfect Capital Mobility under Flexible and Fixed Exchange Rates

Structure of Lecture:

Mundell Fleming Model: Initial Equilibrium and The Four Cases

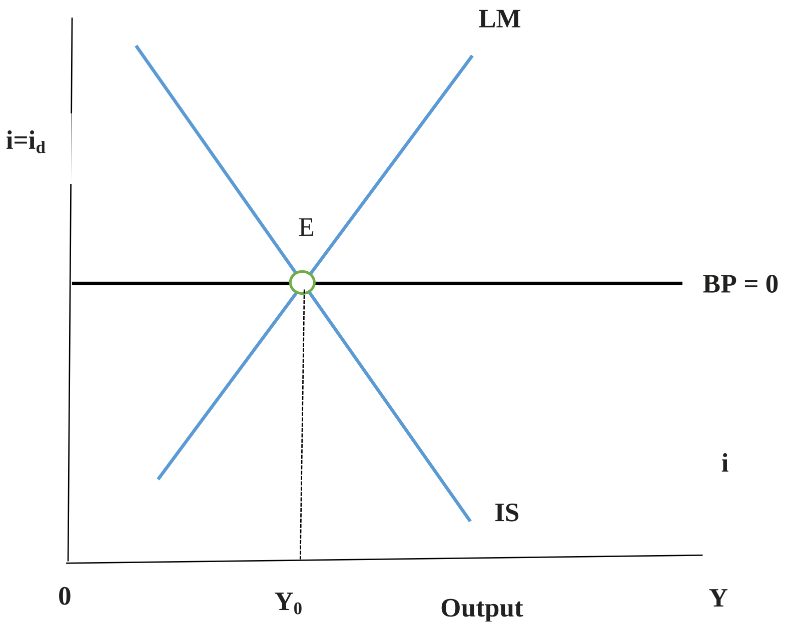
Perfect Capital Mobility with Flexible Exchange Rates

Case 1: Expansionary Fiscal Policy: Totally Non-Effective
Case 2: Expansionary Monetary Policy: Fully Effective

Perfect Capital Mobility with Fixed Exchange Rates

Case 3: Expansionary Fiscal Policy: Fully Effective
Case 4: Expansionary Monetary Policy: Totally Non- Effective

Initial Equilibrium (IS=LM=BP): Simultaneous Equilibrium in Goods Market, Money Market and Balance of Payments

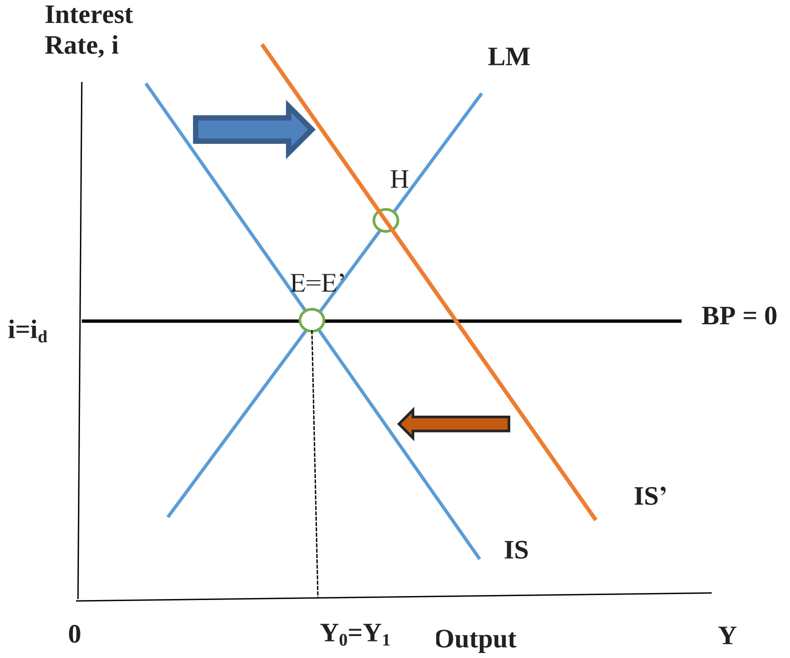


Mundell Fleming Model

Perfect Capital Mobility with Flexible Exchange Rates

Case 1: Expansionary Fiscal Policy: Totally Non-Effective

Figure 1: Fiscal Expansion under Flexible Exchange Rates



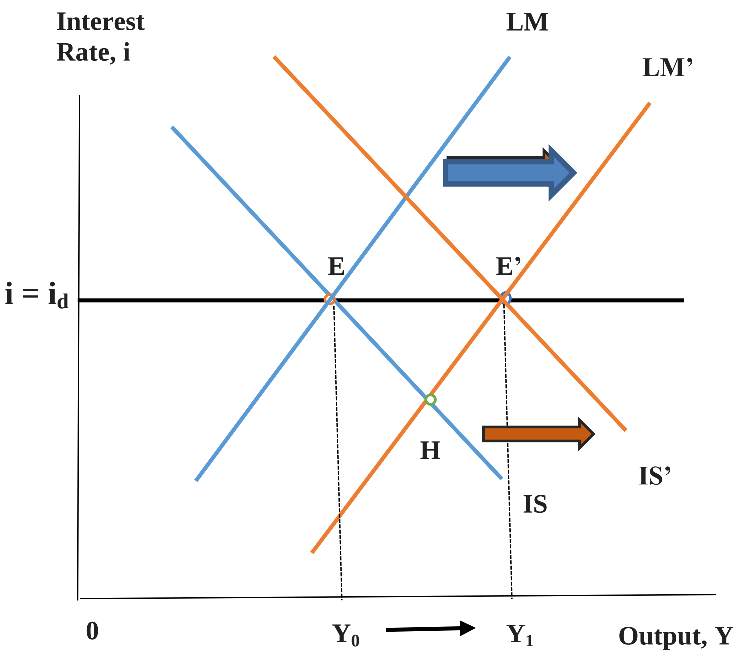
Let Original Equilibrium be at E.

- Domestic Interest equals International Rate of Interest
- Expansionary Fiscal Policy shifts IS to IS'
- Temporarily, id > i (At Point H)
- Huge Capital Inflow to Domestic Country
- Demand for Domestic Currency Increases
- Domestic Currency Appreciates
- Exports Decrease; Imports Increase
- Net Exports Decline
- IS Shifts inwards until reaches IS'
- Income comes back to Y_0

Finally: No Change in Income; Currency has appreciated; NX has fallen; Current Account is Worse Off; and Interest returns to i = id

Case 2: Expansionary Monetary Policy: Fully Effective

Figure 2: A Monetary Expansion under Flexible Exchange Rates



Let Original Equilibrium be at E.

- Domestic Interest equals International Rate of Interest
- Expansionary Monetary Policy shifts LM to LM'
- Temporarily, id < i (At Point H)
- Huge Capital Outflow from Domestic Country
- Demand for Foreign Currency Increases
- Domestic Currency Depreciates
- Exports Increase; Imports Decrease
- Net Exports Increase
- IS Shifts outwards until reaches IS'
- Income increases from Y_0 to Y_1

(So, shift in LM is followed by a shift in IS as well)

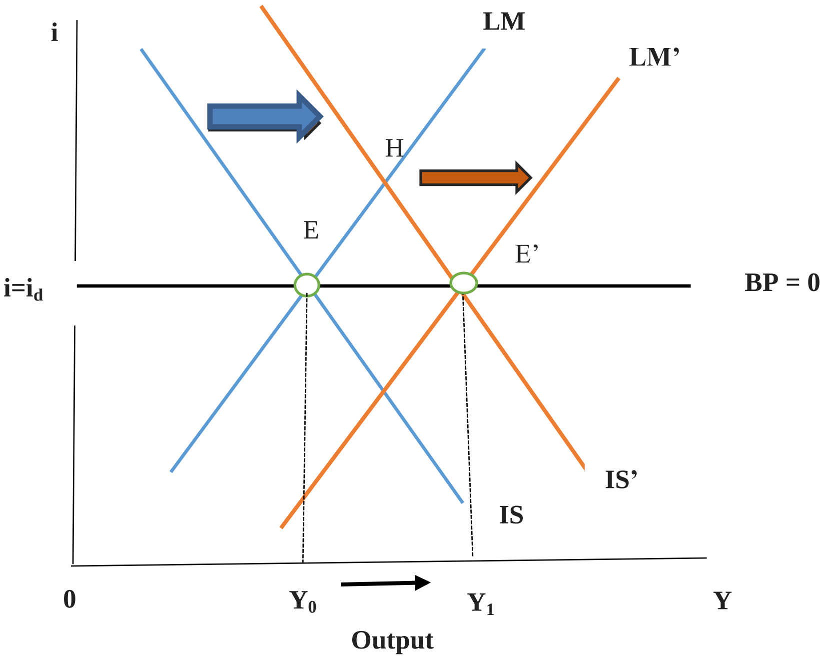
Finally:

Income increases to Y_1; Currency has depreciated; NX increases; Current Account Improves; and Interest returns to i = id

Perfect Capital Mobility with Fixed Exchange Rates

Case 3: Expansionary Fiscal Policy: Fully Effective

Figure 3: Fiscal Expansion under Fixed Exchange Rates



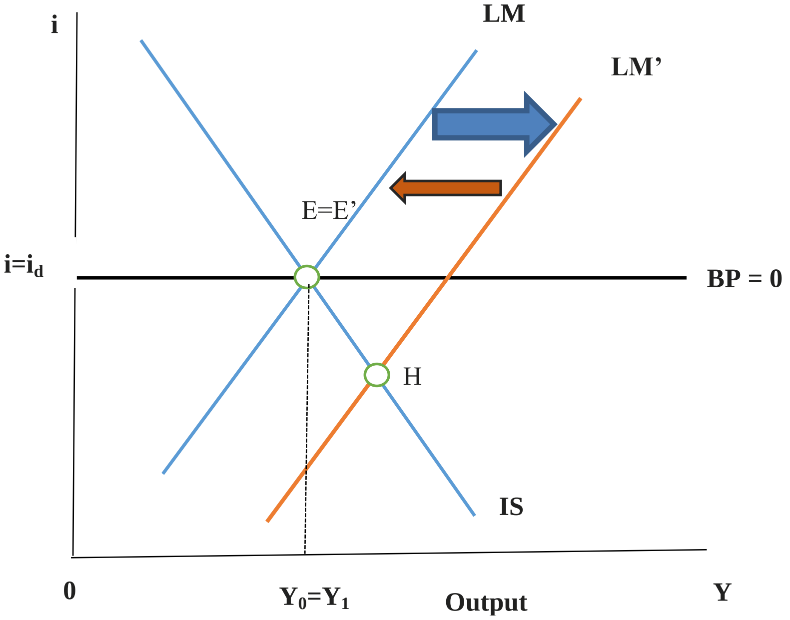
Let Original Equilibrium be at E.

- Domestic Interest equals International Rate of Interest
- Expansionary Fiscal Policy shifts IS to IS'
- Temporarily, id > i (At Point H)
- Huge Capital Inflow to Domestic Country
- Demand for Domestic Currency Increases
- **Tendency for** Domestic Currency to Appreciate
- **But Domestic Currency cannot appreciate, as Fixed Exchange rate**
- To keep Exchange rate Unchanged, Government accepts foreign Currency and Releases Domestic Currency in exchange
- Money Supply Increases; LM shifts to LM'
- Income increases from Y_0 to Y_1

Finally: Income Increases; Currency Remains Fixed; Increase in Domestic Income from Y_0 to Y_1 increases Imports thereby NX falls; Current Account is Worse Off; and Interest returns to i = id

Case 4: Expansionary Monetary Policy: Totally Non- Effective

<u>Figure 4: Monetary Expansion under Fixed Exchange Rates</u>



Let Original Equilibrium be at E.

- Domestic Interest equals International Rate of Interest
- Expansionary Monetary Policy shifts LM to LM'
- Temporarily, id < i (At Point H)
- Huge Capital Outflow from Domestic Country
- Demand for Foreign Currency Increases
- **Tendency for** Domestic Currency to Depreciate
- **But Domestic Currency cannot depreciate, as Fixed Exchange rate**
- To keep Exchange rate Unchanged, Government Buys Domestic Currency and releases Foreign Currency
- Money Supply Decreases; LM' shifts back to LM
- Income comes back to Y_0

Finally:

No Change in Income; Currency Remains Fixed; and Interest returns to i = id

Summary Effects: Monetary and Fiscal Policy under Perfect Capital Mobility

	Fixed Exchange Rates	Flexible Exchange Rates
Monetary Expansion	• No Output Change • Reserve Losses Equal to Money Increase • No Change in Exchange Rate • i = id	• Output Expansion • Trade Balance Improves • Exchange Depreciation • i = id
Fiscal Expansion	• Output Expansion • Trade Balance Worsens • No Change in Exchange Rate • i = id	• No Output Change • Reduced Net Exports • Exchange Appreciation • i = id

Concluding Remarks: Beggar Thy Neighbour Policy and Competitive Depreciation

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