

An Application of the Mundell Fleming Model

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Consider an application of the Mundell Fleming Model – a small open economy. I will present an alternative explanation to the example I did in section today.

We wish to analyze the influence of a restriction on international trade (making the economy less open / an increase in protectionism). The specific form of the trade restriction is a quota on imports on imported goods. The economy operates under flexible exchange rates.

A quota on imports will not affect exports. However, a quota will restrict the amount of imports coming into the country. Thus, the amount of imports will decline. Recall that:

$$NX = EX - IM$$

and therefore net exports must increase *absent* a change in the exchange rate. This causes an outward shift in the net export curve.

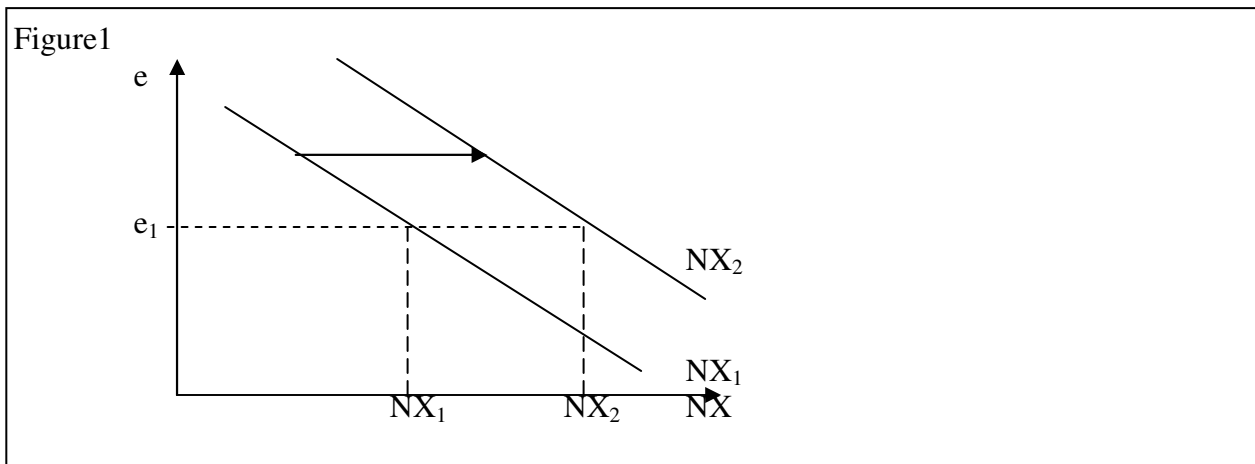
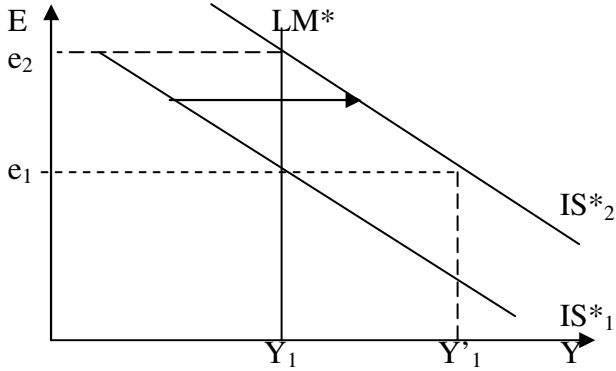


Figure 1 depicts this shift out in net exports. If the exchange rate remains fixed at e_1 the amount of net exports will now be higher. But, this economy has flexible exchange rates.

The IS^* curve must shift to the right. Consider if the exchange rate is the same, net exports must increase so Y must also increase because net exports will not affect the amount of consumption, investment or government purchases.

As you can see in figure 2, at the given exchange rate of e_1 the amount of Y must be greater after the import restriction because net exports is larger for the given exchange rate. But, this is not a solution to the model because there are no changes in the money market (and this point does not represent an equilibrium). Instead, the exchange rates adjust so that there is no change in Y and the economy moves to its original level of Y and to the given exchange rate, e_2 . This also implies that there is no change in the amount net exports even though the curve has shifted out. In other words the shift in the net exports curve is *exactly offset* by the reduction in net exports due to the increase in the exchange rates.

Figure 2



Now, consider the case of the fixed exchange rate. Here, the country must maintain its exchange rate. Thus, the amount of net exports cannot be offset by an increase in the exchange rate. Rather, the country has a shift to the right in the LM^* curve which will result in a higher level of Y and thus also a higher level of net exports. See Figure 3.

Figure 3

