Mundell-Fleming Model

The Mundell–Fleming model also known as the IS-LM-BoP model is an economic model first set forth (independently) by Robert Mundell and Marcus Fleming. The Mundell-Fleming Model (MFM) describes the workings of a small economy open to international trade in goods and financial assets, and provides a framework for monetary and fiscal policy analysis. The model explains the causes of short-run fluctuations in aggregate income in an open economy.

The following are the basic assumption of the model:

1) The domestic rate of interest (r) is equal to the world rate of interest (r*)

2) There is small open economy with perfect capital mobility.

3) It assumes fixed price level.

The main prediction from the Mundell-Fleming model is that the behaviour of an economy depends crucially on the exchange rate system it adopts- whether it operates a floating exchange rate system or a fixed exchange rate system.

The Open Economy IS Curve: In the Mundell-Fleming model, the market for goods and services is expressed by the following equation:

$Y = C(Y - T) + I(r^*) + G + NX(e)$

Where all the terms have their usual meanings. Here investment depends on the world rate of interest r* since r = r* and NX depends on the exchange rate e which is the price of a foreign currency in terms of domestic currency.

The Open Economy LM Curve: The equilibrium condition of the money market in the Mundell-Fleming model is expressed as: $M = L(r^*, Y)$

since $r = r^*$.

Here the supply of money equals its demand and demand for money varies inversely with r* and the positively with Y. In this model, M remains exogenously fixed by the central bank.

General Equilibrium:

As the one shown in the below diagram, it depicts the general equilibrium of goods market and the money market. The equilibrium income (Y_0) and exchange rate (e_0) are determined simultaneously at point A where the IS and LM curves intersect.

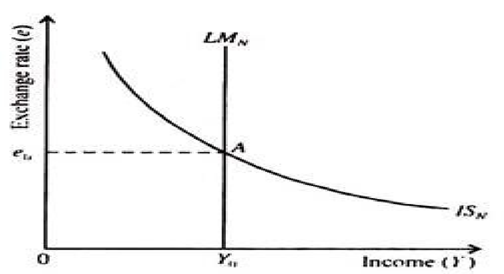

Fig. 12.3 General Equilibrium in MF Model

To conclude, the main message of the Mundell-Fleming model is that the effect of any economic policy (fiscal, monetary or trade) depends on the exchange rate system of the country under consideration, i.e., whether the country is following a fixed or a floating exchange rate system.