Answer on Question #65435-Economics-Macroeconomics

Ineffectiveness of fiscal policy under flexible exchange rate

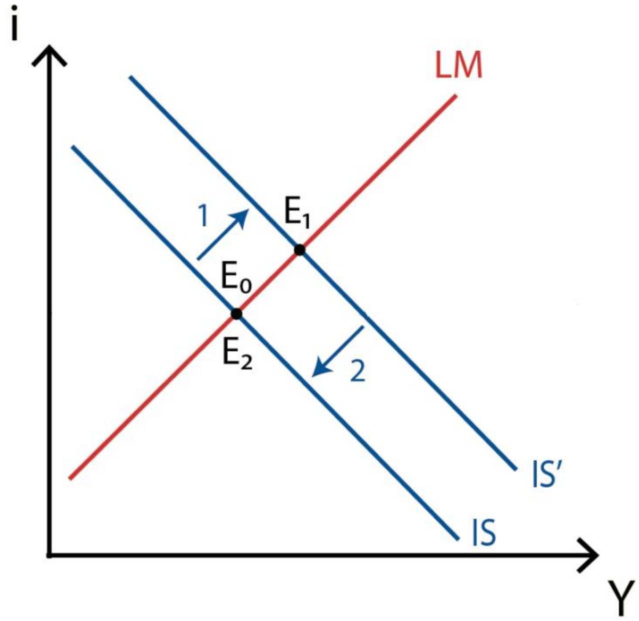
Answer

According the Mundell-Fleming model, fiscal policy under flexible exchange rate is ineffective.

The IS curve in the IS–LM model is defined by the equation:

$Y = C(Y - T(Y)) + I(i) + G + NX(E))$

Fiscal policy shifts the IS curve. Let's assume that policy is expansionary. Income rises and quantity of money demanded increases simultaneously. IS curve will be shifted to the right (IS'). IS shift result in both higher income (Y) and interest rate (i). Increased interest rate attracts capital inflow and that is why domestic currency appreciates (from E_0 to E_1) (to make investments one needs to convert more to national currency). In its turn stronger domestic currency causes decline in net export (domestic goods become more expensive) shifting IS back to the original equilibrium (i) and (Y).



Therefore, fiscal policy will change exchange rate (nominal and real). Both Income and output maintain at their previous level.

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