University of Bern
International Finance

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Handout 5: Economic Policy Under Perfect Capital Mobility

1 The standard IS-LM model

$$Y + IM = C + I + G + EX \quad \text{or} \quad Y = C + I + G + NX$$

NX = Net exports

1.1 The IS curve:

$$I(r) + G + NX(q, Y, Y^*) = S(Y) + T(Y)$$

$$q = ep^*/p$$

changes in e shift the IS curve

1.2 The LM curve:

$$M = pf(Y,i) = k(i, v)pY$$

M consists of both domestic credit and foreign reserves

1.3 Foreign transactions

Interest Rate Parity (UIRP)

$$i - i^* = e(t+1) - e(t)$$

Position of the IRP curve: higher e(t+1) or i* shift the curve out

2 Short term effects of fiscal and monetary policy under

2.1 Flexible system

Monetary

Temporary monetary expansion: Lower interest rates, domestic currency depreciation, output expansion

Permanent monetary expansion: Lower interest rates (?), domestic currency depreciation, output expansion

Fiscal

Temporary fiscal expansion: Higher interest rates, domestic currency appreciation, output expansion

Permanent fiscal expansion: No effect on interest rates, domestic currency appreciation, no effect on output

2.2 A Fixed System

Monetary policy is completely ineffective
Fiscal policy is effective