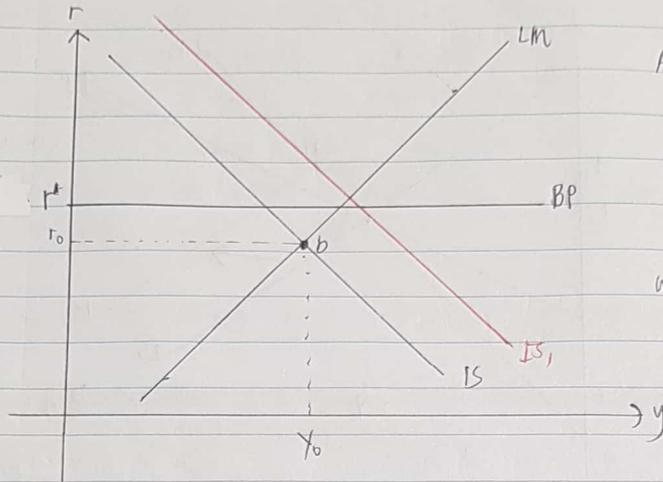


Expansionary Fiscal Policy under Perfect Capital Mobility



At pt. b, there is BP deficit with  $r^* > r_0$  which means that  $CAD > KAS$ . The BP curve won't move as it is fixed. But, with the shift of IS curve to the right, the economy will have a BP surplus where  $KAS > CAD$ . Here, currency appreciates and thus, exports will have to go down ( $Y^* \downarrow$ ) & this will continue until the IS curve shifts back to the left bec. of  $\downarrow E$  (currency appreciation)

**CONCLUSION:**  $\uparrow$  in  $G$  is completely ineffective in  $\approx$  perfect capital mobility. Overall, there is no change; however, the composition/components of GDP actually changed (i.e.  $I \approx X$ )

PROBLEM SET 7 MUNDALL FLEMING IS-LM-BP MODEL

Exercise 1: Given planned expenditure = actual expenditure

$$Y = \bar{C} + c(Y - T + \bar{TR}) + \bar{I} - lr + G + X - mY + zE$$

i) How do equal increases in  $G$  and  $T$  affect the position of the IS curve?

Derive the mathematical expression  $\frac{dY}{dG}$  for a given level of  $r$  and  $E$ . Use lump sum tax rather than marginal tax rate.

Solution

$$Y = C + I + G + X$$

$$= [\bar{C} + c(Y - T + \bar{TR})] + [\bar{I} - lr] + G + [X - mY + zE]$$

Noting for the exogenously fixed variables:  $[\bar{C} + c\bar{TR} + \bar{I} + X - mY^*]$ ,

$$Y = [\bar{C} + c\bar{TR} + \bar{I} + X - mY^*] + \underbrace{[G - cT]}_{\text{policy}} + (c - m)Y - lr + zE$$

Take total derivative:

$$\rightarrow dY = dG - c dT + (c - m) dY - l dr + z dE$$

\* Balanced Budget:  $dG = dT > 0$

$$\frac{dY}{dG} = \frac{dG}{dG} - c \frac{dT}{dG} + (c - m) \frac{dY}{dG} - l \frac{dr}{dG} + z \frac{dE}{dr} \cdot \frac{dr}{dG}$$

a  $\Delta$  in  $G$  impacts  $E$  (nominal  $ER$ ) through  $r$  (interest rate)