13. Monetary & Fiscal Policies for Internal & External Balance

Q:1 Explain the Mundell Fleming Model ?

A **Mundel- Fleming Model :-** According to Mundell-Fleming model, an economy cannot simultaneously maintain a fixed exchange rate, free capital movement and an independent monetary Policy. An economy can only maintain two of the three at the same time.

This model is an extension of the IS-LM model which is developed by Robert Mundell and Marcus Fleming.

According to Mundell Fleming View, monetary Policy and Fiscal Policy have different relative impacts on internal and External balance.

Due to restrictive monetary policy, rate of interest increase which encourage Foreign Capital Inflow.

Due to restrictive Fiscal Policy, government adopt budget surplus policy or increase tax rate. It will discourage Foreign capital inflow.

Thus according to Mundell, Monetary Policy has great effect on the External balance as compare to Fiscal Policy; because foreign capital and Investment is more affected due to change in Rate of interest.

(B) Assumptions :-

1. This theory assumed a Small Open economy with Perfect capital mobility.
2. monetary Policy is mostly related to Changes in rate of interest. The domestic rate of interest is equal to World rate of interest.
3. Fiscal Policy is related to Surplus budget or Deficit budget
4. Spot and Forward Exchange Rates are Same.
5) Production is Subject to Constant Return to Scale.
6) Money wage-Rates are fixed. Thus domestic Price-level is remain Constant.
7) Taxes and Savings increase with income.
8) The Balance of Trade (BOT) depend upon income and exchange Rate.

(C) Use of Monetary and fiscal policy For Internal and External Stability :-

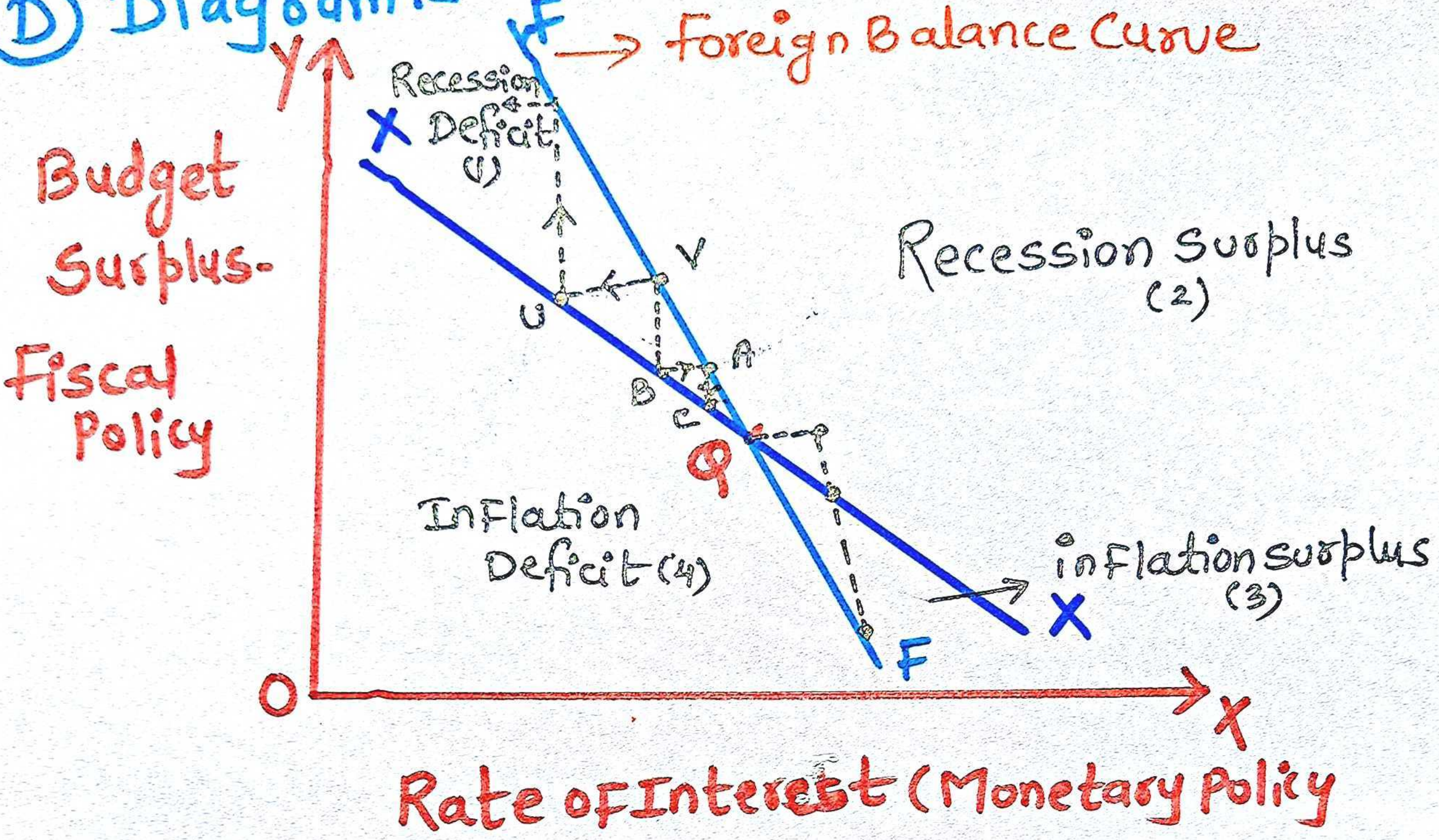
Internal balance requires that Aggregate Demand for domestic output Should be equal to Aggregate supply of domestic output at Full-employment Level. There Domestic out put should not be inflationary or Recessionary Pressure.

External balance shows that the Balance of Trade is equals to Net Capital Exports at the fixed exchange Rate.

IF Balance of Trade > Capital Exports → **Surplus BOP and exchange Rate Appreciate.**

IF Balance of Trade < Capital Exports → Deficit BOP. **and exchange Rate Depreciate**

(D) Diagram :-



In above diagram we Observe :-

1) FF-Line is the foreign balance curve which shows Locus of pair of interest-rates and budget surpluses which shows balance of Payment is in equilibrium.
2) FF-Line Shows a Negative slope because increase in the interest rates will reduce Capital Out Flow. It reduce consumption expenditure and Imports which improve BOP Position.
3) But due to decrease in Budget surplus will increase government expenditure and Domestic consumption expenditure. It increase the imports of goods which result in Deficit BOP Position.

4) Thus any Point on FF Curve shows that - increase in interest rate will result in Surplus BOP Position which have to Compensated by a reduction in the Surplus Budget to achieve equilibrium in BOP Level.

5) XX-line shows Internal balance of the economy. It is the Locus of the Pair of interest rates and Budget Surplus which maintain Internal balance.

6) Line-XX has a Negative slope because an increase in interestrate will reduce budget Surpluses.

7) Points above and to the right side of XX-line shows Recession but Points below and to the Left side of Line-XX shows inflation.

8) Line-XX intersect Line FF at Point-Q. Here economy enjoys equilibrium with internal and External balance.

9) There Four-Disequilibrium Levels between internal and External balances -

1 - Recession and Deficit BOP Position
2 - Recession and Surplus BOP Position
3 - Inflation and Surplus BOP Position
4 - Inflation and Deficit BOP Position.

(E) Two Possible Combinations

1. Stable Policy Combination
2. Unstable Policy Combination

1. Stable Policy Combination :- According to Mundell, the government must use monetary Policy to achieve External balance and fiscal Policy for internal balance. It will helps to bring stability in economy.

Example :- In above figure - Deficit BOP starts from Point-B. To Correct this deficit, government increase rate of interest to - A Level. This restrictive monetary Policy will Create recession Problem which Can be solved by a Expansionary fiscal Policy. It will help our economy to reach at equilibrium - Q.

2. Unstable Policy Combinations :- According to Mundell, when government Use fiscal Policy to achieve external balance and Monetary Policy to achieve internal balance then it will bring Unstable Conditions in the economy.

Example :- In above figure - Deficit BOP starts from Point-B. To Correct this deficit, government Use fiscal Policy and try to increase Budget Surplus upto Point-V on FF-Line. At Point V we can get equilibrium in Balance of Payment but it create recession Problem. To Solve the Problem of recession, by monetary Policy, government has to reduce rate of interest to U. This will again result in. Deficit in BOP. Again there is need to increase in budget Surplus till equilibrium Level is achieved. Thus this Combination is Unstable.

F) Policy Measures For internal and External balance :-

i) **Recession + Bop Deficit** :- Here government has to raise Rate of Interest to achieve equilibrium in BOP and Deficit Budget must be Followed to reduce Problem of Recession.

ii) **Inflation + Bop Surplus** :- Here government has to reduce Rate of Interest to achieve equilibrium in BOP. and Surplus Budget must be followed to reduce Problem of Inflation.

iii) **Recession + Bop Surplus** :- Here government has to reduce Rate of Interest to achieve equilibrium in BOP. and Deficit Budget must be Followed to reduce Problem of Recession.

iv) **Inflation + BOP Deficit** :- Here government has to raise Rate of interest to achieve equilibrium in BOP. and Surplus Budget must be Followed to reduce Problem OF Inflation.

C) Criticism OF the Model :-

1. **Ignore StagFlation Problem** :- StagFlation is a Situation in which inflation and Unemployment both exist

in the economy. This theory do not Consider Problem of stagflation which mostly found in Developed countries.

2. Long-time Lags :- This theory assumed that there are no time Lags for the working of monetary and fiscal Policies. But in reality both monetary and fiscal Policies require Long time gap to achieve internal and external balance.

3. Neglect Other Factors :- Monetary theory mainly focused on Rate of Interest for Capital Investment. But there are many other factors Like exchange Rate Variations, Servicing of Public Debt etc. are neglected by this theory.

4) Practical Restrictions :- Monetary and fiscal Policies are working under some Practical restrictions. Due to Political reasons some policies do not follow restrictive fiscal and monetary Policies.

5) Retards Capital Formation :- When restrictive monetary Policy raise the rate of interest, it will increase capital investment and capital inflow in Home country. Even government will increase Public Expenditure or reduce taxation. Thus Overall capital formation of economy can be improved. But this will increase Burden of External Borrowings.

6. Not a true adjustment mechanism :-

Monetary and Fiscal Policy Combination is not a true adjustment system to adjust BOP Position but they help to bring stability in the economy.

Conclusion :- A monetary and fiscal policy Combinations Correct disequilibrium in the balance of Payment and Proper maintain internal and External balance.

Q:2 Explain the Assignment Problem in Internal and External Balance ?

A Assignment Problem :-

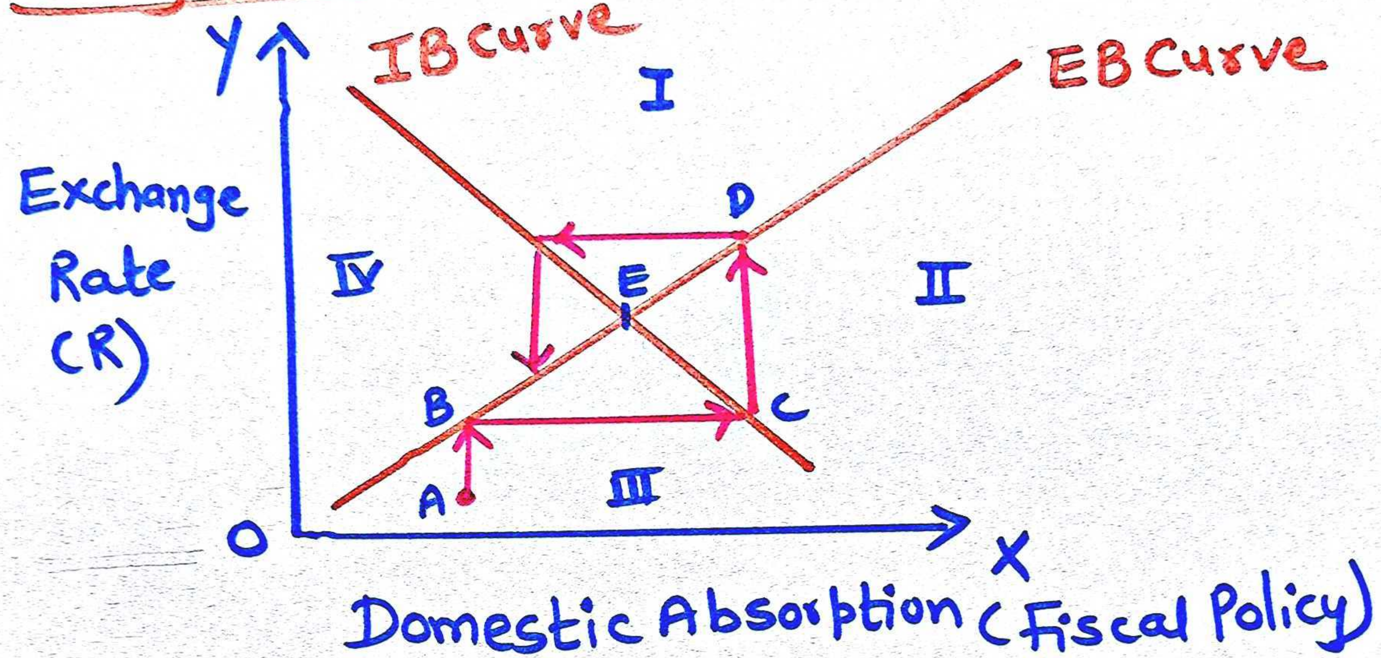
In economy the Central Bank determine the exchange Rate - R and the Central Government determine fiscal Policy - G. But there is no effective Policy Co-ordination between central bank and Central Government.

So the main Question arise that which authority - Central Bank that fixes - R or Central Government that fixes G should be responsible for External balance - EB and which should be responsible for Internal balance - IB. This Question is known as Assignment Problem.

IF the two instruments are Exchange Rate and fiscal Policy the best way is to rely on Exchange Rate to achieve External balance and fiscal Policy to achieve internal balance.

Thus – Fiscal Policy → IB (Internal Balance)
Exchange Rate Policy → EB (External Balance)

Diagram :-



In above figure we Observe that –

1) Assignment of Exchange Rate to External balance is a Correct Choice. Suppose economy starts from Point-A where the is BOP-Deficit and Unemployment
2) Now Central bank adopt appropriate Devaluation of Currency which move the economy Vertically Upward to B Point to reach EB curve.
3) Now Fiscal Expansion move the economy to rightside till it reaches to IB – at Point C.
4) Now Further Devaluation moves economy Vertically Upward From C to D (Reach at EB Curve). But at Point-D there is inFlationary Pressure.
5, Now Central Government, Use Contractionary fiscal i.e. by reducing Govt. Exp. or increasing Taxes to reach IB Curve.

6) This Process will Continue till –

External Balance = Internal balance = Equilibrium

EB = IB = E

Thus the Assignment Problem relates to the assignment OF instruments to targets. The Problem of Pairing targets and instruments is called Assignment Problems. It Suggests that the Choice of Policy to achieve goals should be based of following guidelines :–

1. Effectiveness of Instruments :–

The instruments should be capable to achieve targets.

Example :– Fiscal Policy will be an effective instrument to increase income, output and employment.

2. Effectiveness of different instruments :–

Each instrument may influence more than one target. So it is desired that instrument should be matched with target so that it brings maximum outcome.

3. Equality of Instruments and Targets :–

To achieve a given targets there must be effective instruments.

Independent Targets = Effective instruments.

When instruments are Less than Targets then targets will not be fully achieved.

When instruments are more than targets then there will be different ways to achieve targets.

4. Independence Of Targets and instruments :-

Both the targets and instruments should be independent

Example :- Balance of Payment Ecouilibrium in Country A & B are not independent. Similarly - instruments like - exchange Rate, tariffs, exports subsidies etc. are not independent. They have relative effects on output and Balance of Payment.

Thus, according to Mundell Fleming Views, Use of monetary Policy for internal balance and fiscal Policy for External balance will Lead to Unstable Situation. But the Use of monetary Policy for External balance and fiscal Policy for Internal balance will Lead to stable Situation.

The Success of the Policy is depends upon that how government and Central Bank Use that Policies as per recquirements and targets.