

A GRAPHICAL DEMONSTRATION OF FISCAL AND MONETARY POLICY WITH FLEXIBLE PRICES

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MUNDELL'S article on "The Appropriate Use of Monetary and Fiscal Policy"¹ filled a gap left by Meade's balance of trade approach.² For the latter, either fiscal or monetary policy could be used to affect the level of income and, concomitantly, the level of imports and the trade balance. An expansionary policy leads to a deterioration of the trade balance, and consequently yields an overall improvement only when unemployment is accompanied by a surplus in the foreign account. A contractionary policy improves the balance of trade and serves internal and external balance only when an economy has inflation and a surplus in the external account. The analysis requires a trade-off between internal and external balance in economies with inflation and a surplus or, on the other hand, unemployment and a deficit. In order to correct imbalances in both sectors a policy instrument must be attached to each goal. By introducing capital flows responsive to interest rate differentials, Mundell was able to show that the balance of payments would be responsive primarily to monetary policy, leaving fiscal policy to deal with the level of national income.

Mundell considers only capital flows; portfolio capital is admittedly ignored. Changes in the interest rate will bring about a redistribution of the allocation of portfolio capital between domestic and foreign investment.³ An increase in the interest rate improves the capital account by increasing the net capital inflow, by attracting foreign portfolio capital, and by redirecting domestic portfolio capital to the home country. Such a large capital movement will provide a greater short-run improvement in the balance of payments

¹ Mundell, Robert, *International Economics*, New York: Macmillan Co., 1968, Ch. 16.

² *Balance of Payments*, London: Oxford University Press, 1956, Part III.

³ Forte, Francesco and Willet, Thomas, "Interest Rate Policy and External Balance", *Quarterly Journal of Economics*, 1969.