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Exchange rate indeterminacy in portfolio balance, Mundell–Fleming and uncovered interest rate parity models

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Abstract

With full stock/flow accounting respected, the two-country open economy portfolio balance model has just two independent equations for asset market clearing. It can determine home and foreign interest rates but not the exchange rate. If asset market equilibria vary smoothly over time, the balance of payments equation in the Mundell–Fleming model is not independent and cannot set the exchange rate either. The familiar fixed reserves/'floating rate' vs endogenous reserves/'fixed rate' dichotomy does not exist, and 'fundamentals-based' econometric models of the exchange rate are bound to fail. An alternative is a two-country IS/LM model with exchange rate dynamics added. Its dynamic properties under uncovered interest rate parity are briefly explored.

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