Topics for Today

1.) Practice with the Mundell-Fleming Model

2.) Currency Crises

3.) Reforming the "International Financial Architecture"
   - The "Open-Economy Trilemma"

4.) The Market-Clearing Approach to Business Cycles
   - The Keynesian AS Curve
   - The Phillips Curve
   - Empirical Failure of Keynesian Models during the 1970s
   - Real Business Cycles

2 Key Ingredients of Mundell-Fleming Model

1.) Small Country + Capital Mobility

$\Longrightarrow r = r_w$

If $r > r_w \Longrightarrow$ Massive Capital Inflows

If $r < r_w \Longrightarrow$ Massive Capital Outflows

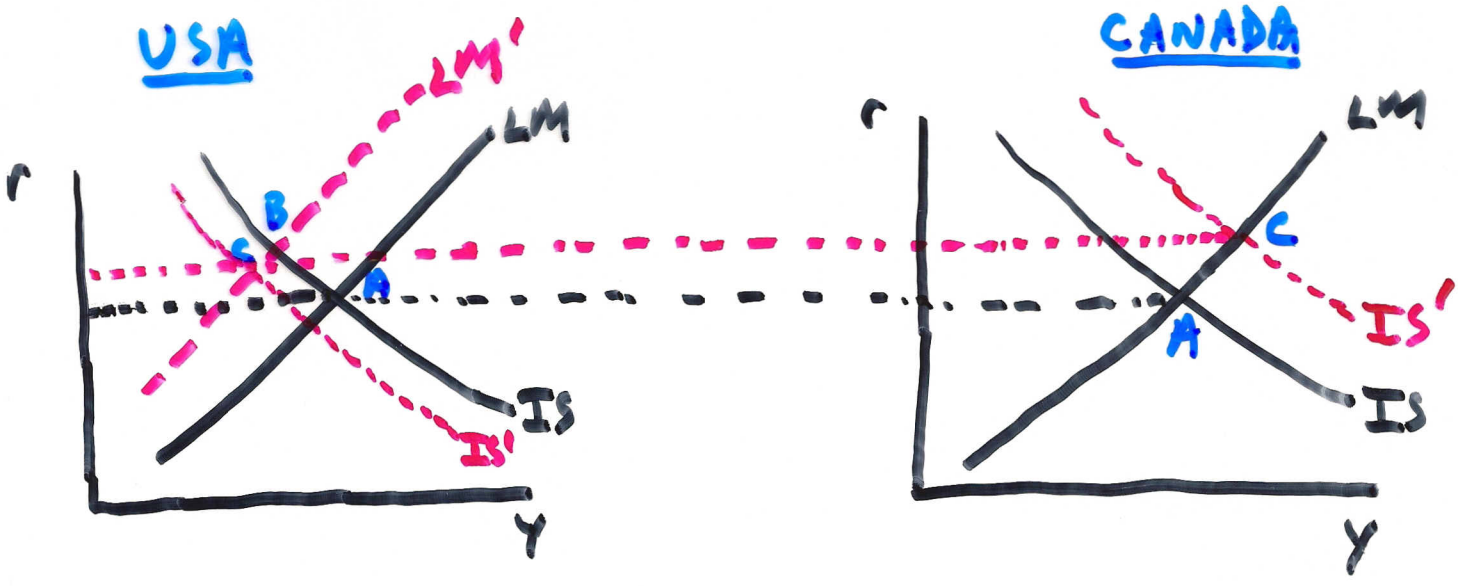
2.) Capital Inflows $\Longrightarrow$ Currency Appreciation (with flexible exchange rates)

$\Longrightarrow$ Increase in Money Supply (with fixed exchange rates)

Capital Outflows $\Longrightarrow$ Currency Depreciation (with flexible exchange rates)

$\Longrightarrow$ Decrease in Money Supply (with fixed exchange rates)

Foreign Financial Crisis



1.) $M^d \uparrow \Rightarrow$ LM shifts Up

2.) $r \uparrow$, $Y \downarrow$, currency appreciates

3.) $NX \downarrow \Rightarrow$ IS shifts down

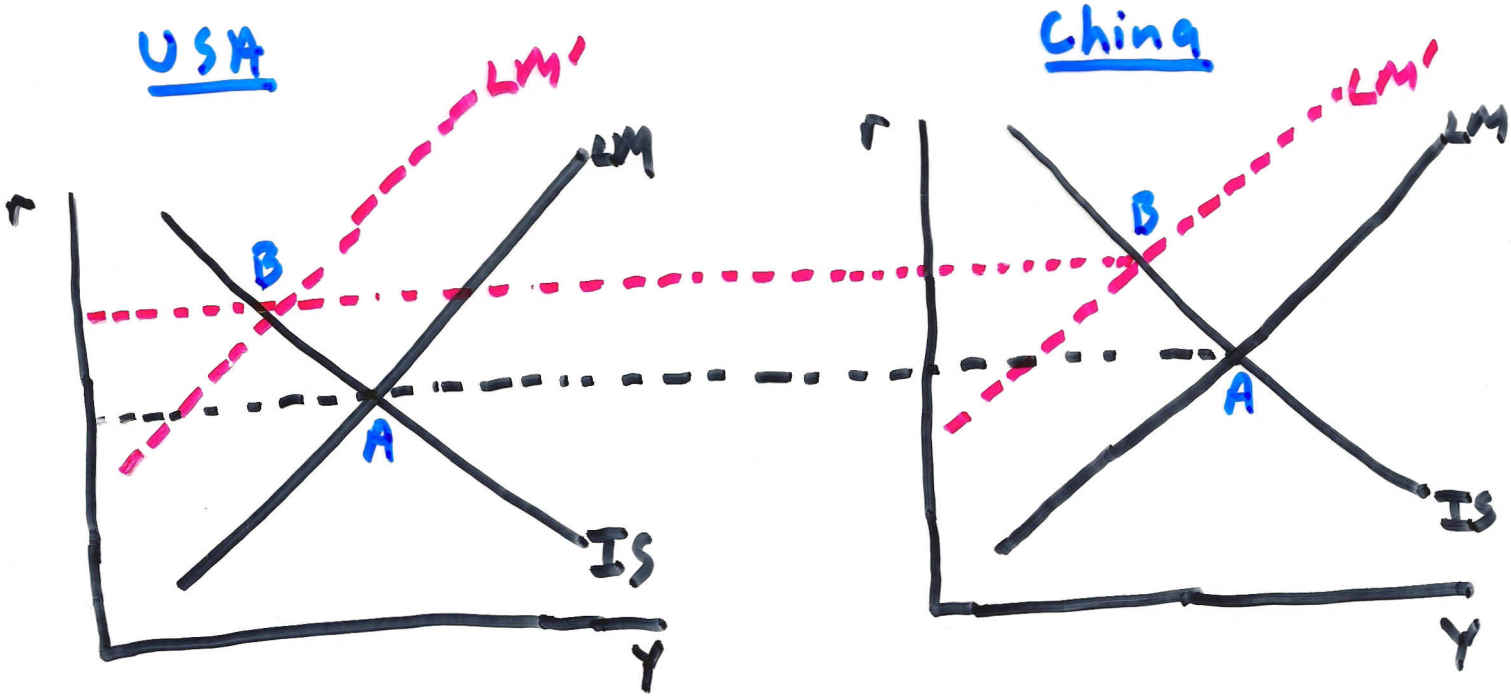
1.) Currency Depreciates $\Rightarrow NX \uparrow$

2.) IS shifts out

3.) $Y \uparrow$!

<u>Qualification</u>: Financial crisis in U.S. could spillover to the Canadian <u>financial markets</u>, and thus affect Canadian LM curve

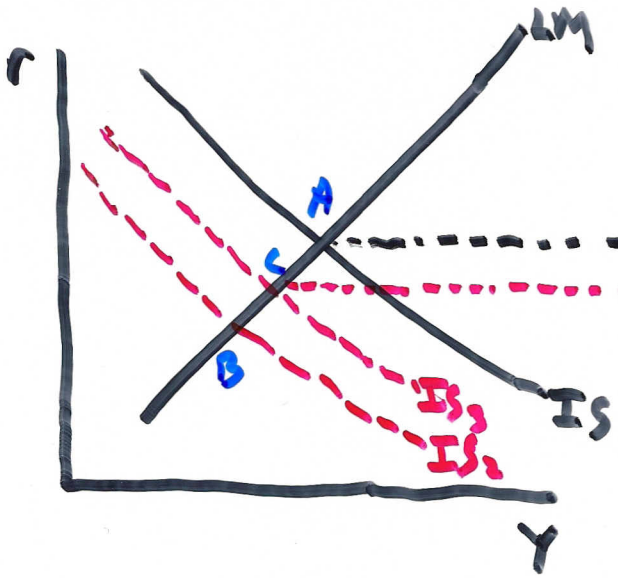
Foreign Financial Crisis



To keep its exchange rate pegged to the U.S. $, China must match the rise in U.S. interest rates. U.S. recession gets transmitted abroad.

Obama Raises Taxes / Cuts Military Spending

USA

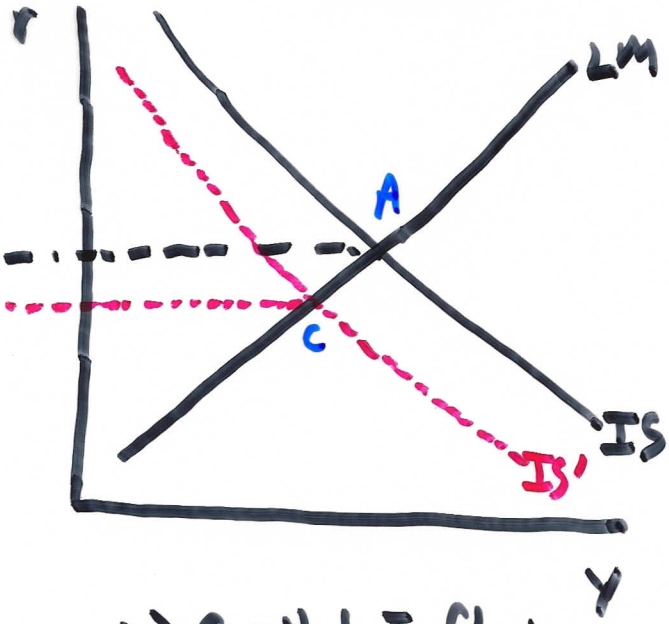


1.) Fiscal Contraction ⇒ IS shifts left

2.) r↓ ⇒ Capital Outflow
Currency Depreciation

3.) NX↑ ⇒ IS shifts partly back

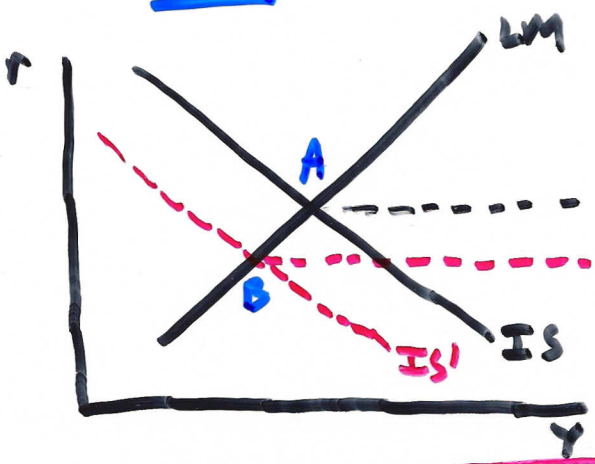
CANADA



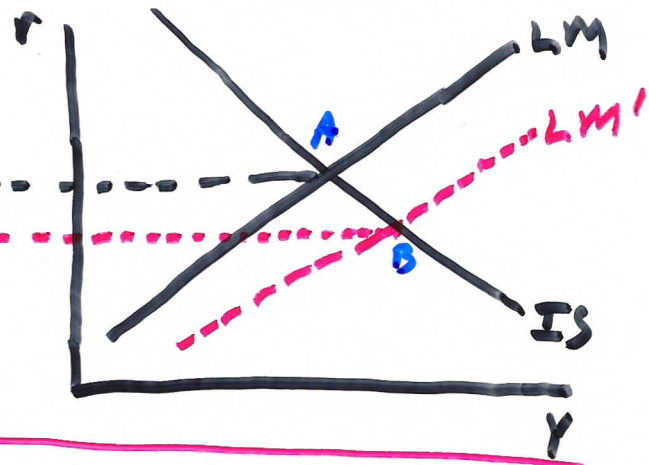
1.) Capital Inflow,
Currency Appreciates

2.) NX↓ ⇒ IS shifts down

USA



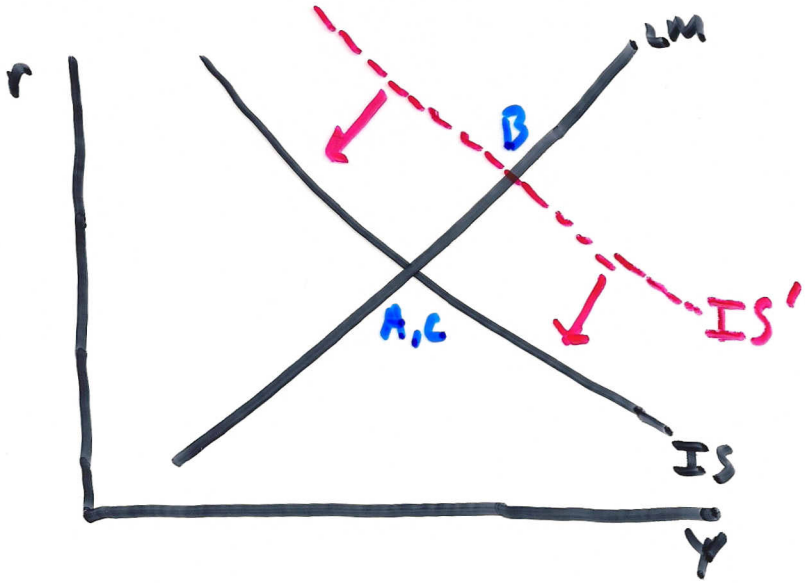
CHINA



To keep its ex. rate fixed to the $, China must match the lower interest rates in U.S.

Import Tariff

Flexible Ex. Rate



Tariff ⇒ Imports More Expensive

⇒ NX ↑

⇒ IS shifts out

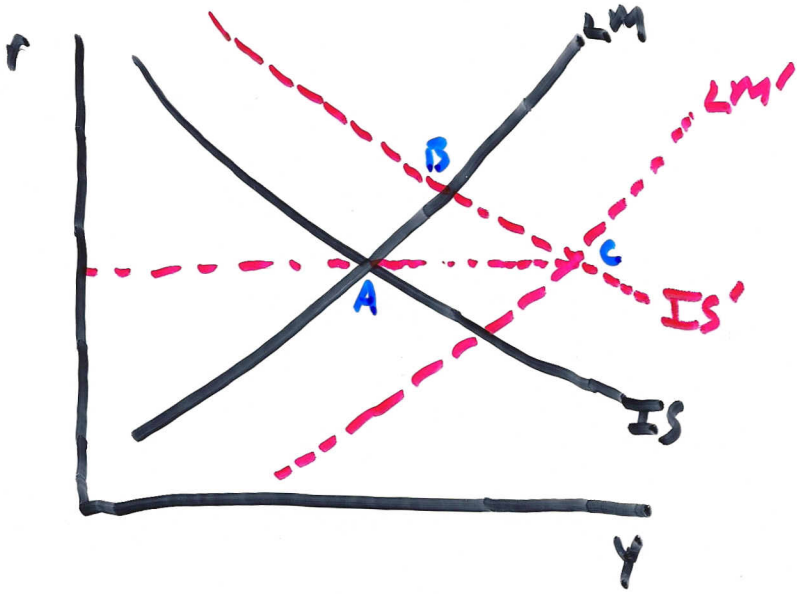
⇒ r ↑, Capital Inflow

⇒ Currency Appreciates

⇒ NX ↓

⇒ No lasting effect on output!

Fixed Ex. Rate



Tariff ⇒ Imports More Expensive

⇒ NX ↑

⇒ IS shifts out

⇒ r ↑, Capital Inflow

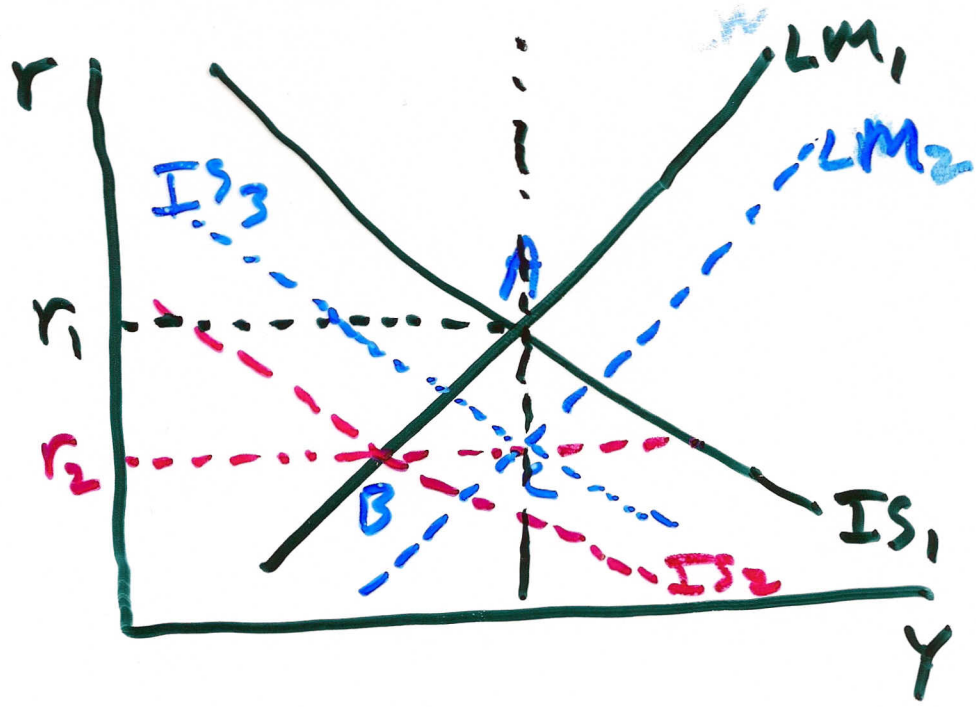
⇒ To prevent currency appreciation, govt. must expand money supply (purchase fx)

⇒ LM shifts out

⇒ Y ↑ in short-run

What happens in Long-Run?

How Should Canada Respond to the U.S. Recession?



The U.S. recession pushes Canada from A to B.

To get back to original output level the Bank of Canada should shift the LM out to LM_2, by cutting interest rates (or expanding the money supply)

Fiscal policy is likely to be relatively ineffective.