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

\[ r = \bar{r}_w \]

If \( r > \bar{r}_w \) \( \Rightarrow \) Massive Capital Inflows

If \( r < \bar{r}_w \) \( \Rightarrow \) Massive Capital Outflows

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

\[ \Rightarrow \text{Increase in Money Supply} \]
   (with fixed exchange rates)

Capital Outflows \( \Rightarrow \) Currency Depreciation
   (with flexible exchange rates)

\[ \Rightarrow \text{Decrease in Money Supply} \]
   (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. $Y \uparrow$

Qualification: Financial crisis in U.S. could spillover to the Canadian financial markets, and thus affect Canadian LM curve.
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 $\Rightarrow$ IS shifts left
2. $r\downarrow \Rightarrow$ Capital Outflow, Currency Depreciation
3. $NX\uparrow \Rightarrow$ IS shifts partly back

**Canada**

1. Capital Inflow, Currency Appreciates
2. $NX\downarrow \Rightarrow$ IS shifts down

**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 $\Rightarrow$ Imports More Expensive

$\Rightarrow$ $NX \uparrow$

$\Rightarrow$ IS shifts out

$\Rightarrow$ $r\uparrow$, Capital Inflow

$\Rightarrow$ Currency Appreciation

$\Rightarrow$ $NX \downarrow$

$\Rightarrow$ No lasting effect on output!

Fixed Ex. Rate

Tariff $\Rightarrow$ Imports More Expensive

$\Rightarrow$ $NX \uparrow$

$\Rightarrow$ IS shifts out

$\Rightarrow$ $r\uparrow$, Capital Inflow

To prevent currency appreciation, govt. must expand money supply ($purchase\ fix$)

$\Rightarrow$ LM shifts out

$\Rightarrow$ $Y \uparrow$ 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 LM2, by cutting interest rates (or expanding the money supply).

Fiscal policy is likely to be relatively ineffective.