Instead of reinforcing the notion that monetary policy is now more effective, the integration of international financial markets has led to questions concerning both steps of the transmission mechanism.[8] The argument is that central banks can no longer control domestic interest rates; changes in money supply growth that would normally cause interest rates to change are outweighed by international capital flows that equalize returns across markets. Further, any movement of interest rates that might have altered aggregate demand are partially offset by the availability of alternative sources of financing and changes in the composition of money holdings.

Nonetheless, research conducted by the IMF, the Federal Reserve Bank of New York and the Bank of Canada all suggest that the effectiveness of monetary policy has not been diminished due to either the liberalization or the internationalization of financial markets.[9] Canada has a relatively long history of financial integration with the United States and the recent growth in international capital flows has had little, if any, negative impact on the ability to conduct Canadian monetary policy.

3.2 Fiscal Policy

As in the above section on monetary policy, we consider the effectiveness of fiscal policy in an environment of flexible exchange rates and mobile capital. While theory suggests monetary policy will be more effective in such an environment, it suggests fiscal policy will be less so. An expansionary fiscal policy, if it is not accompanied by an easing of monetary policy, will cause domestic interest rates to rise. The increase in interest rates will attract foreign capital, causing the domestic currency to appreciate and net exports to decline. The decline in net exports will at least partially offset the fiscal stimulus.

Just as the trade sector has become more important to the transmission of monetary policy, it has also become more important to fiscal policy. However, instead of making fiscal policy more effective, as is the case with monetary policy, the

[8] See, for example, White, *op. cit.*, p. 12.

[9] For a discussion of financial market integration and the effectiveness of Canadian monetary policy, see J. Murray and R. Khemani, *International Interest Rate Linkeages and Monetary Policy: A Canadian Perspective.* Technical Report No. 52. Ottawa: Bank of Canada, December 1989, p. 39. For discussions of monetary policy and the interest sensitivity of output, see International Monetary Fund, "Effectiveness of Monetary Policy After Financial Market Liberalization." In *World Economic Outlook.* Supplementary Note 5, 1991, p. 105, and B. Hirle and J. Kelleher, "Financial Market Evolution and the Interest Sensitivity of Output." In *Quarterly Review.* New York: Federal Reserve Bank of New York, Summer 1990, pp. 56-70. For an explanation of what other factors can effect the transmission mechanism see W. White, *op. cit.*, p. 12.