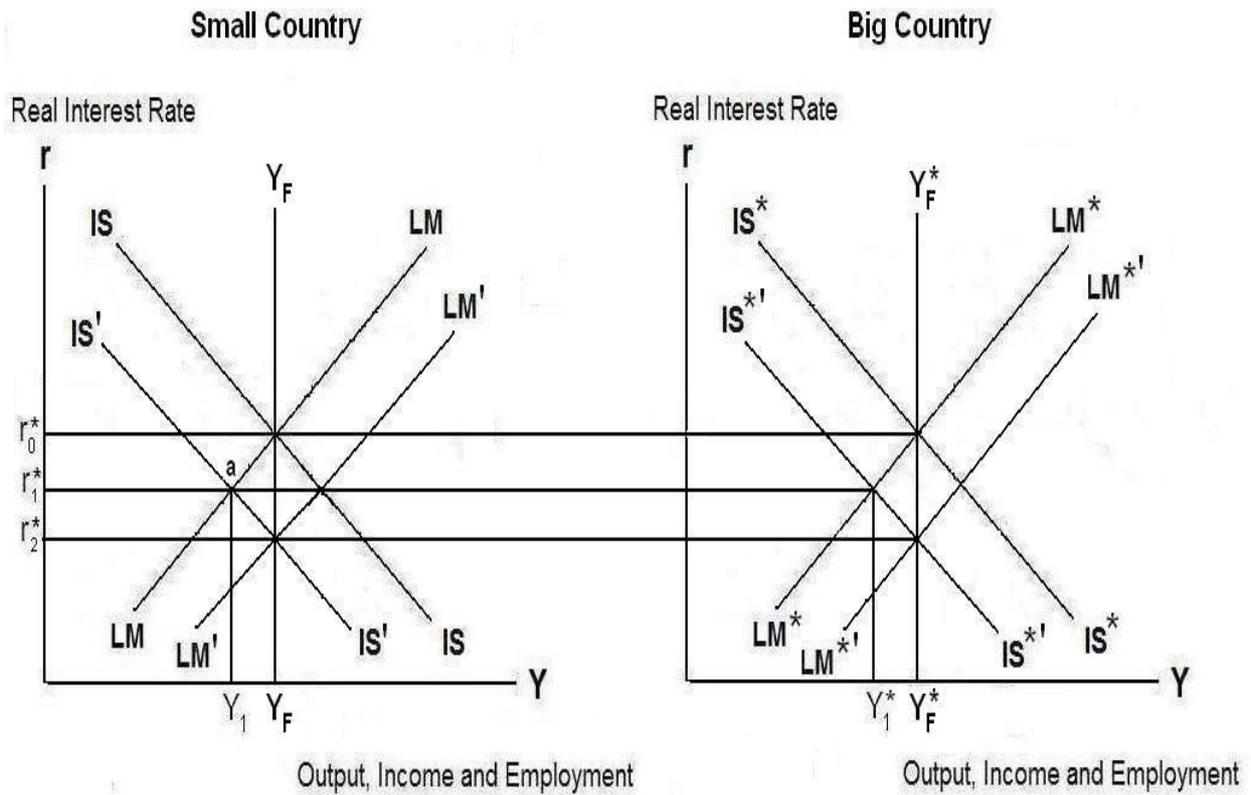


**Figure 2. Small Country Response to Big Country Real Shocks:
Flexible Exchange Rate**



As we can see from the figure above, under flexible exchange rate the decrease in world income will cause IS curve shift to the left, so both output and real interest rate will decrease. And then in the long run the LM curve will shift to the right, so the level of the output will move back, but the real interest rate will decrease again.