IS-LM Model

Goods Market equilibrium: IS

- AD = C + I + G + NX
- Equilibrium—Y= AD

  Y=C + I + G + NX
- In 2-dimension, Y =C + I = C + S

  I = S
- S→ Y (directly), I →r (inversely)
- Slope of IS curve—negatively sloped (downward sloping)

Shift in IS Curve

- Change in autonomous spending—
  - Changes in government spending
  - Change in taxes
  - Autonomous change in investment
  - Transfer payments

Money Market Equilibrium: LM curve

- $M_d = L(Y, r)$
  - M_d depends inversely with r and directly with Y
  - M_d is down ward sloping
- M_s is controlled by the central bank of the country –
  - constant at given time
  - Vertical curve
- LM curve is the locus of pair of interest rates and levels of income which are compatible with money market.
- Any point to the right of the LM curve there is an excess demand for money and at any point to the left there is an excess supply of money.
- Slope of LM—positively sloped (Upward sloping)

Shift in the LM Curve

- Changes in the money supply
- Shifts in the money demand function

Monetary policy—Money Influences—Shift in LM curve

- Effects of Changes in Money Supply
  - Keynesian Case—partially effective
  - Liquidity Trap—not effective
  - Classical Case—maximum effect
- Effects of Shift in Money Demand Function
  - Increase in money demand (portfolio shifts away from bonds into money)—Y decline
  - Same effect as a decline in the quantity of money

Fiscal Policy—Real Influences—Shift in IS curve

- Fiscal policy is the instrument of the government to achieve a number of socio-economic objectives.
- It can influence production, consumption and resource allocation.
- Main Instruments of Fiscal Policy
  - Taxation
  - Public expenditure
  - Public Debt
  - Deficit financing