IS – LM Model

The IS – LM model, which stands for "investment – savings" (IS) and "liquidity preference – money supply" (LM) is a Keynesian macro economic model that shows how the market for economic goods (IS) interacts with the loanable funds market (LM) or money market.

IS – LM Intersection

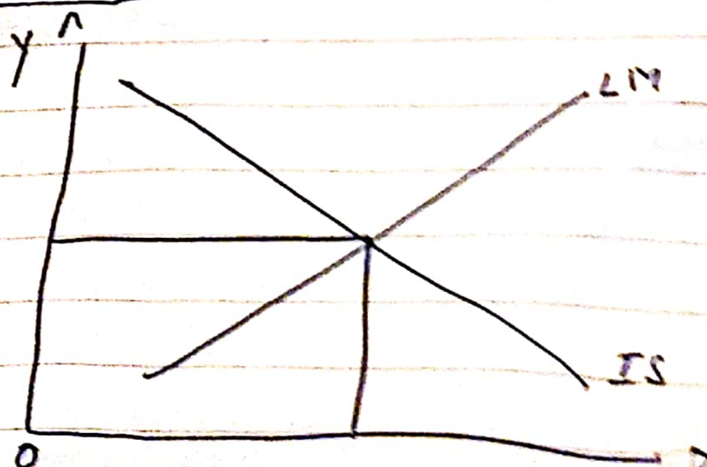

Fig (1)

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In the short run the economy moves to the IS and LM curve as given in the above fig.

Production adjust to demand to put the economy on the IS curve.

Bond prices and interest rate adjust to achieve equilibrium in financial ~~[illegible]~~ market, putting the economy on the LM curve.

Business Cycle Fluctuations.

A shift in either the IS curve or the LM curve can cause a business cycle fluctuation. Different economic factors shift the IS-LM curve, so the curve shifts independently.

A ~~[illegible]~~ change in the aggregate demand shifts the IS curve but not the LM curve.

A change in the demand or supply of money or bonds, shifts the LM curve but not the IS curve.

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Exogenous Price Level:

For an economy in recession, Keynesians take the price level as exogeneous. Any drop in price level in response to excess supply is minimal.

Monetary Policy:

Monetary Policy is exogeneous. With the price level taken as exogeneous, the money supply set the position of the LM curve.

Expansionary monetary policy shifts the LM curve down (fig 2). The money supply increases, and the interest rate falls. The economy moves down along the IS curve: the fall in the interest rate raises investment demand, which has a multiplier effect on consumption.

Expansionary Monetary Policy

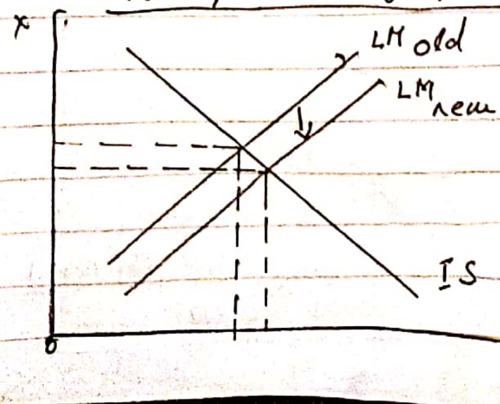

Fig (2)

Fiscal Policy

Fiscal Policy is exogenous. The level of government expenditure and taxation and the tax code set the position of the IS curve.

Fiscal Policy has no direct effect on the LM curve. Increased govt. spending or a tax cut is assumed to be financed by borrowing. The money supply does not change so the LM curve does not change.

Expansionary fiscal policy shifts the IS curve to the right (fig 3). The multiplier effect on consumption raises the national income and product. The increase in the interest rate partially offsets the expansionary effect.

Expansionary Fiscal Policy

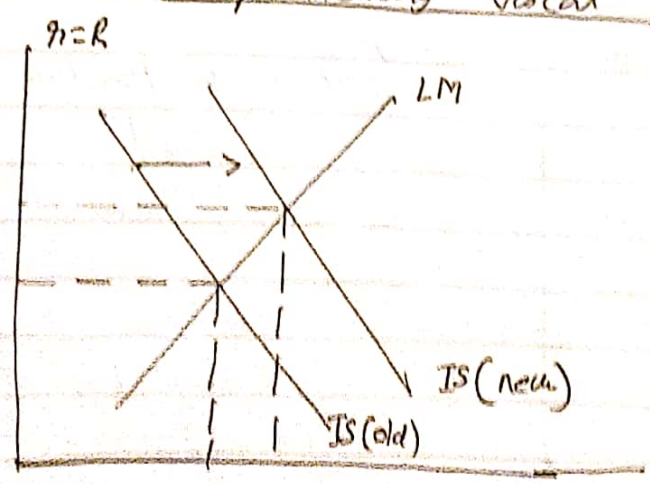

Fig (3)

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Disequilibrium not Equilibrium

The Keynesian IS-LM model is a model of disequilibrium not equilibrium.

The IS curve does not represents the condition that demand equals supply of goods.

Instead the IS curve represents the condition that demand equals product.

The Key takeaway of the IS LM Model:

(1) The IS-LM model describes how aggregate markets for real goods and financial markets interact to balance the rate of interest and the the total output in the macro economy.

(2) IS-LM model was devised as a formal graphic representation of the Keynesian economic theory.

(3) IS-LM model can be used to describe how changes in market preferences alter the equilibri. levels of GDP and market rates of interest,

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but the model lacks the precision and realism to be a useful prescription tool for economic policy.

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