

GENERAL EQUILIBRIUM : The interaction of IS and LM functions

The real market equilibrium gives us the IS curve that depicts various combinations of income and rate of interest at which savings and investments are in equilibrium. Similarly, the money market equilibrium gives such combinations of income and rate of interest which brings the demand for money and supply of money into equality. If there is a simultaneous equilibrium in both the markets

SUNDAY 21

The entire system is considered to be

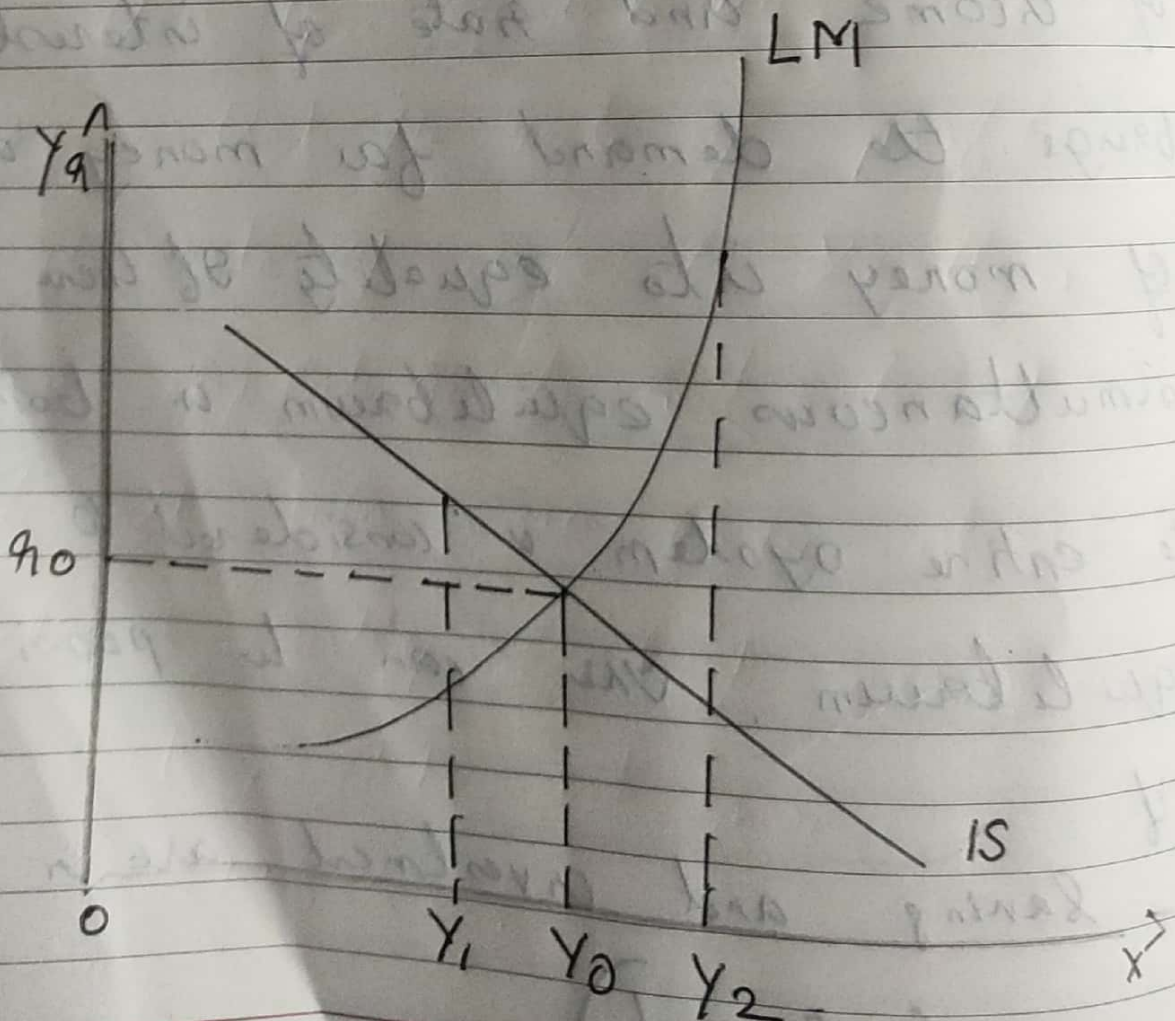
equilibrium. This can be possible only

if

(i) Savings and investment are in equilibrium

$$(S = I)$$

(iii) demand for money is equal to supply of money ($M_D = M_S$)
 In other words, a solution of the rate of interest can be achieved through the intersection of the IS and LM function. It has been explained through the fig given below.



Notes

The above big shows that there is one unique income-interest rate combination that keeps both the goods and monetary sectors of the economy into equilibrium. This combination is r_0 rate of interest and Y_0 level of income.

If the level of income is less than Y_0 say Y_1 , IS curve lies above the LMI curve. It shows that yield on capital goods (rate of profit) exceeds the money rate of interest (the yield on securities).

An excess of profit rate over the rate of interest will stimulate investment which

turn will expand income through the multiplier process. An increase in income will lead to the release of speculative balance

24 APRIL

WEDNESDAY

DAYS LEFT WK 17

| | | | | | | | | | |
|----|----|----|----|----|----|----|----|----|----|
| 11 | 12 | 13 | 14 | 15 | 16 | 17 | 18 | 19 | 20 |
| 21 | 22 | 23 | 24 | 25 | 26 | 27 | 28 | 29 | 30 |
| 31 | | | | | | | | | |

A supplement to transaction balances.

This will cause a rise in the rate of interest.

On the other hand, increased investment will

bring down the rate of profit. Thus, the yield

on capital goods and the yield on securities

to be equal to at r_0 at Y_0 level of income.

The system is in equilibrium. Thus if we

suppose the income (Y_2) of the community

greater than the equilibrium income (Y_0),

it means that the rate of profit is less

than the rate of interest. Finally, the

yield on capital goods and rate of interest

are brought into equilibrium at r_0 rate

of interest and Y_0 level of income, where

both real market and money market are

in equilibrium.

Notes

22 | 27 28 29 30
WKR 17 DAYS 115-250 THURSDAY

Limitations of IS - LM model:

Many economists, including Keynes, objected to IS-LM model for its simple assumptions about the macro economy. In fact, Hicks admitted that the model's flaws were fatal, and it was best used as a class room gadget. The model is a limited policy tool, as it cannot explain how tax or spending policies should be formulated with any specificity. This significantly reduces its functional appeal.