Equilibrium of Goods and Money Market

The IS-LM model finds the value of income and interest rate which simultaneously clears the goods and money market.

The interest rate and the income level should be such that both the markets are in equilibrium. The IS-LM shows the interaction between the goods and the money market.

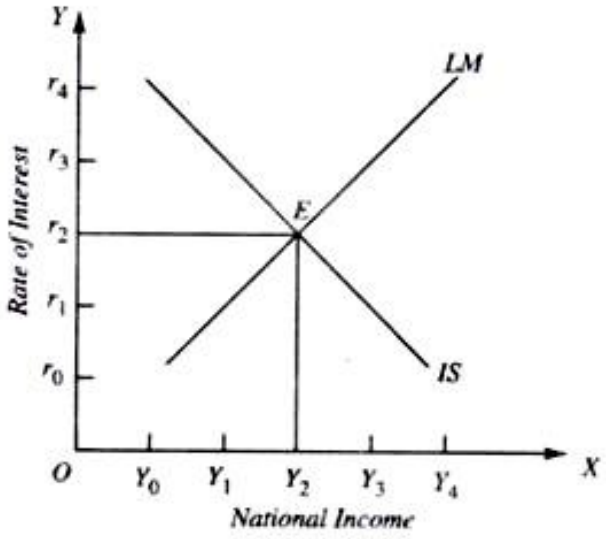
The model finds the value of income and the interest rate which simultaneously clears the goods and the money market. It appears that the equilibrium income level cannot be determined without first knowing the rate of interest and the interest rate cannot be determined without first knowing the income level.

The IS and the LM curves relate the two variables:

(a) Income and

(b) The rate of interest.

Income and the rate of interest are therefore determined together at the point of intersection of these two curves, i.e., E in figure. The equilibrium rate of interest thus determined is Or_2 and the level of income determined is OY_2. At this point income and the rate of interest stand in relation to each other such that (1) the goods market is in equilibrium, that is, the aggregate demand equals the level of aggregate output, and (2) the demand for money is in equilibrium with the supply of money (i.e., the desired amount of money is equal to the actual supply of money). It should be noted that LM curve has been drawn by keeping the supply of money fixed.



Thus, the IS-LM curve model is based on:

(1) The investment-demand function,

(2) The consumption function,

(3) The money demand function, and

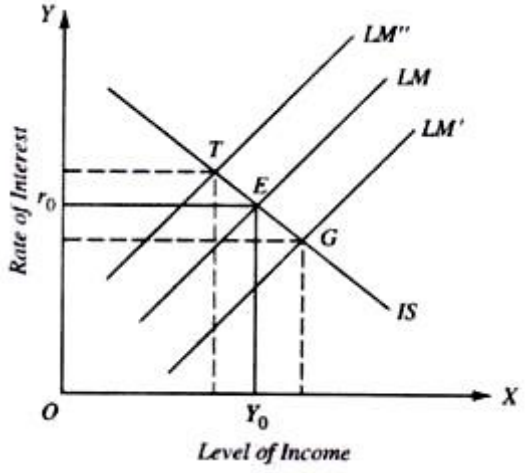
(4) The quantity of money.

We see, therefore, that according to the IS-LM curve model both the real factors, namely, saving and investment, productivity of capital and propensity to consume and save, and the monetary factors, that is, the demand for money (liquidity preference) and supply of money play a part in the joint determination of the rate of interest and the level of income. Any change in these factors will cause a shift in IS or LM curve and will therefore change the equilibrium levels of the rate of interest and income.

The IS-LM curve model explained above has succeeded in integrating the theory of money with the theory of income determination. And by doing so, as we shall see below, it has succeeded in synthesizing the monetary and fiscal policies. Further, with the IS-LM curve analysis, we are better able to explain the effect of changes in certain important economic variables such as desire to save, the supply of money, investment, demand for money on the rate of interest and level of income.

Effect of Changes in Supply of Money on the Rate of Interest and Income Level:

Let us first consider what will happen if the supply of money is increased by the action of the Central Bank. Given the liquidity preference schedule, with the increase in the supply of money, more money will be available for speculative motive at a given level of income which will cause the interest rate to fall. As a result, the LM curve will shift to the right.



With this rightward shift in the LM curve, in the new equilibrium position, rate of interest will be lower and the level of income greater than before. This is shown in figure where with a given supply of money, LM and IS curves are intersecting at point E.

With the increase in the supply of money, LM curve shifts to the right to the position LM', and with IS schedule remaining unchanged, new equilibrium is at point G corresponding to which rate of interest is lower and level of income greater than at E. Now, suppose that instead of increasing the supply of money, Central Bank of the country takes steps to reduce the supply of money.

With the reduction in the supply of money, less money will be available for speculative motive at each level of income and, as a result, the LM curve will shift to the left of E, and the IS curve remaining un-changed, in the new equilibrium position (as shown by point T in figure) the rate of interest will be higher and the level of income smaller than before.