

The Short-Run: IS/LM

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Issues

- ▶ In the growth models we studied aggregate demand was irrelevant.
- ▶ We always assumed there is enough demand to employ all factors / sell all output.
- ▶ Why is this appropriate for long-run analysis?

The Short and the Long Run

Short run: supply is elastic

- ▶ only demand matters
- ▶ IS/LM model

Long run: output is on its trend growth path

- ▶ only supply matters
- ▶ capital stock adjusts
growth models

Medium run: supply depends on prices

- ▶ demand and supply matter
- ▶ price setting mechanisms push output towards trend
- ▶ AS/AD model
- ▶ the transition from short to long run

Why Isn't There One Model?

In state of the art research, there actually is one model.

It has the price adjustment **frictions** that give rise to unemployment, business cycles, ...

It has **capital accumulation** that matter for long-run output (growth)

It has an explicit transition path between short run and long run equilibrium

- ▶ over time, prices adjust and demand becomes less and less important

Objectives

In this section, we are concerned with the short-run IS-LM model

You will learn:

1. how to set up and interpret the IS-LM model
2. what its limitations are
3. how to solve for the equilibrium
4. how to analyze the effects of shocks and policies

All of this is review of material you previously learned in Intermediate Macro.

IS-LM Model

Key assumptions:

- ▶ Output is determined by aggregate demand
- ▶ There is no supply side
- ▶ Prices are fixed
- ▶ Closed economy

Think: economy in recession, with lots of unemployed resources.

We relax all of these assumptions later.

IS-LM Model

Two markets

- ▶ Goods (IS). Money (LM)
- ▶ In the background there is also a bond market

Two endogenous variables

- ▶ Output (Y). Interest rate (i)

Two policy variables

- ▶ Government spending (G). Money supply (M)

The Goods Market: IS Curve

Aggregate Demand

Start from an identity

$$Z = C + I + G + X - IM$$

Z is aggregate demand / expenditure.

For now: closed economy with $X - IM = 0$.

Add behavioral assumptions to give it content.

Consumption function

$$C = C(Y_D) = c_0 + c_1 Y_D \quad (1)$$

$Y_D = Y - T$: disposable income (after taxes and transfers)

c_0 : “autonomous consumption” (intercept)

c_1 : marginal propensity to consume (slope)

$s = 1 - c_1$: marginal propensity to save

Consumption might also depend on wealth, interest rates, expected incomes, etc.

► these are stuffed into c_0

Investment function

$$I = I(Y, i) = \bar{I} + b_1 Y - b_2 i \quad (2)$$

Investment depends on:

- ▶ interest rate i : cost of capital
- ▶ output Y : aggregate demand
- ▶ expectations etc (again stuffed into the intercept \bar{I})

Government

- ▶ Exogenous G and T .
- ▶ G is government consumption
- ▶ T is tax revenue net of transfer payments

Goods Market Clearing

Assumption: supply is perfectly elastic.

$$Y = C + I + G \quad (3)$$

$$= [c_0 + c_1(Y - T)] + [\bar{I} + b_1Y - b_2i] + G \quad (4)$$

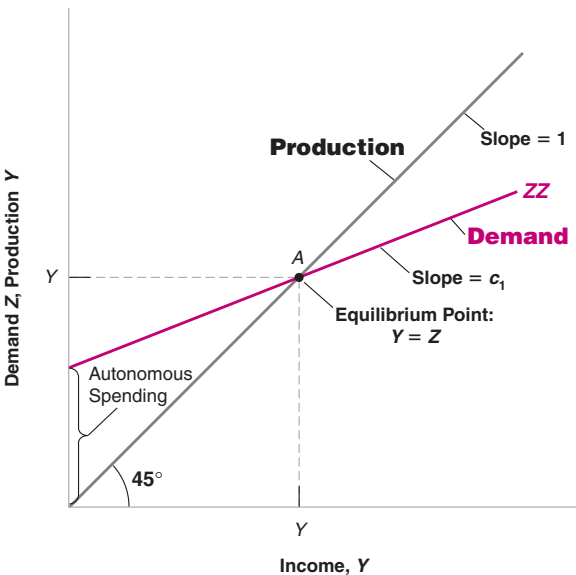
$$= \underbrace{[c_0 + \bar{I} + G - c_1T]}_{\bar{Z}} + (c_1 + b_1)Y - b_2i \quad (5)$$

\bar{Z} : autonomous spending / demand

Solve to get the IS curve:

$$Y = \frac{\bar{Z} - b_2i}{1 - c_1 - b_1} \quad (6)$$

Goods Market Clearing

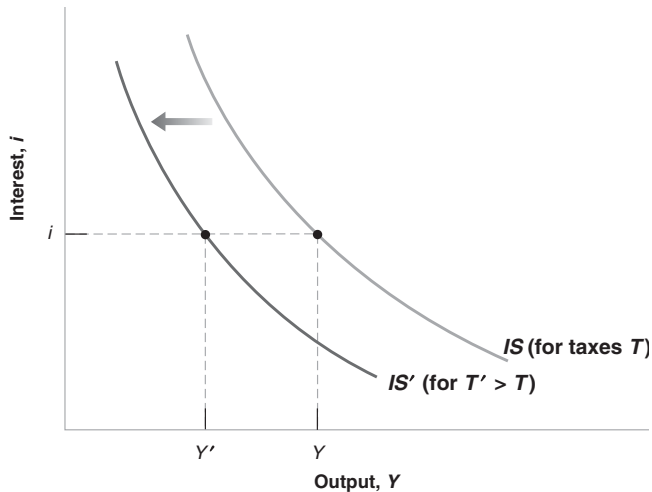


Demand:

$$Z = \bar{Z} + (c_1 + b_1)Y - b_2i.$$

What happens when the interest rate i rises?

IS Curve



IS collects all (Y, i) for which the goods market clears.

Intuition: IS Curve

Why is IS downward sloping?

Shifting the IS Curve

Only autonomous demand \bar{Z} shifts IS

Example: $G \uparrow$

- ▶ Excess demand \rightarrow Need higher i to reduce I
- ▶ New IS curve shifted up

What else shifts IS?

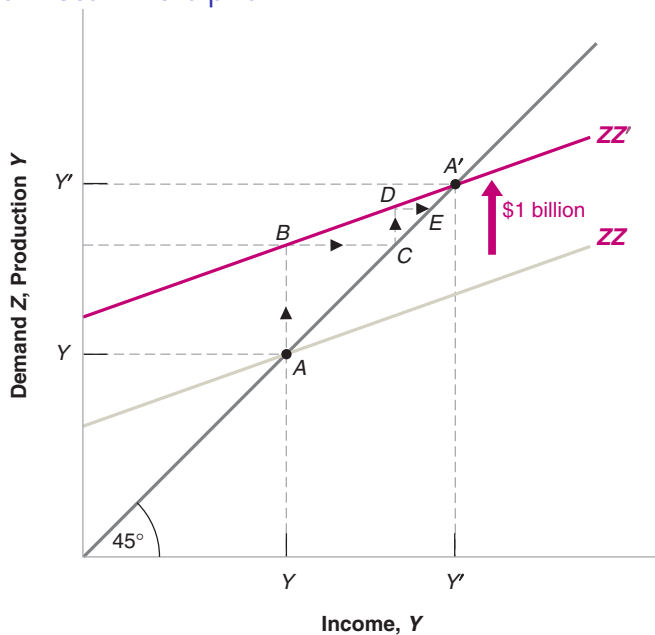
Clearly distinguish moving along the curve vs. shifting the curve!

The Fiscal Multiplier

$$Y = \frac{\bar{Z} - b_2 i}{1 - c_1 - b_1} \quad (7)$$

- ▶ Increasing government spending by \$1 \implies increasing Y by $1/(1 - c_1 - b_1)$.
- ▶ This holds the interest rate constant (which will not be true in equilibrium)
- ▶ Intuition:

The Fiscal Multiplier



Saving Equals Investment

We can also think about goods market clearing as equating saving with investment.

Private saving:

$$S = Y_D - C = Y - T - C \quad (8)$$

Public saving:

$$S^P = T - G \quad (9)$$

Total saving equals investment:

$$I = Y - T - C + T - G \quad (10)$$

This yields goods market clearing

$$Y = C + I + G \quad (11)$$

The Money / Bond Market: LM Curve

LM Curve

The LM curve equates supply and demand of “money.”
What is “money”?

Money Demand

How to divide wealth between “money” and bonds?

- ▶ Money: liquidity benefit
- ▶ Bonds: interest benefit

Division depends on

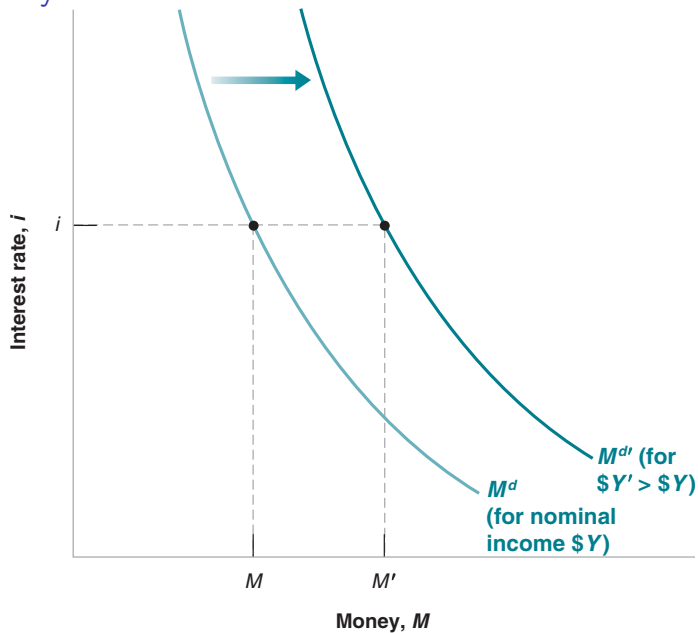
- ▶ transactions volume (nominal income)
- ▶ interest rate

Money demand can then be written as

$$M^d = \$Y \times L(i) \quad (12)$$

$\$Y$ is nominal income (in dollars)

Money Demand



Money Supply

Real world: money = [currency] + [checkable deposits]

Currency: controlled by CB

Checkable deposits: created by banks

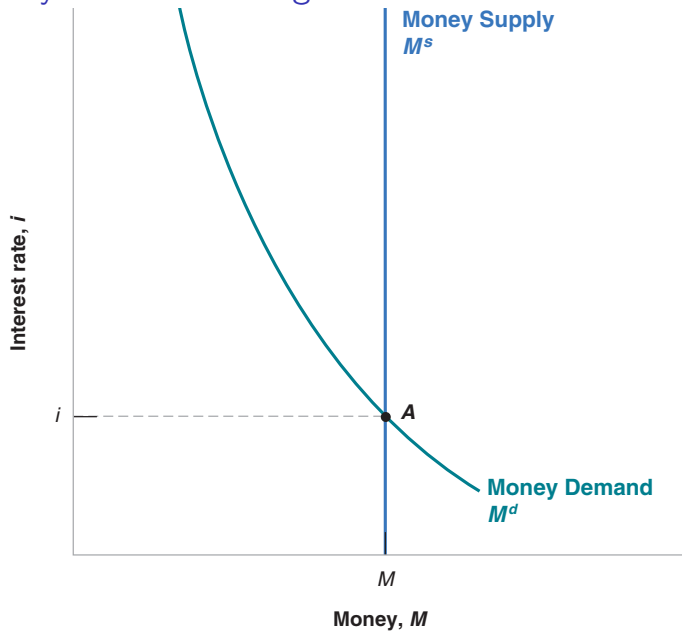
For now: assume that CB controls money supply

$$M = M^s \quad (13)$$

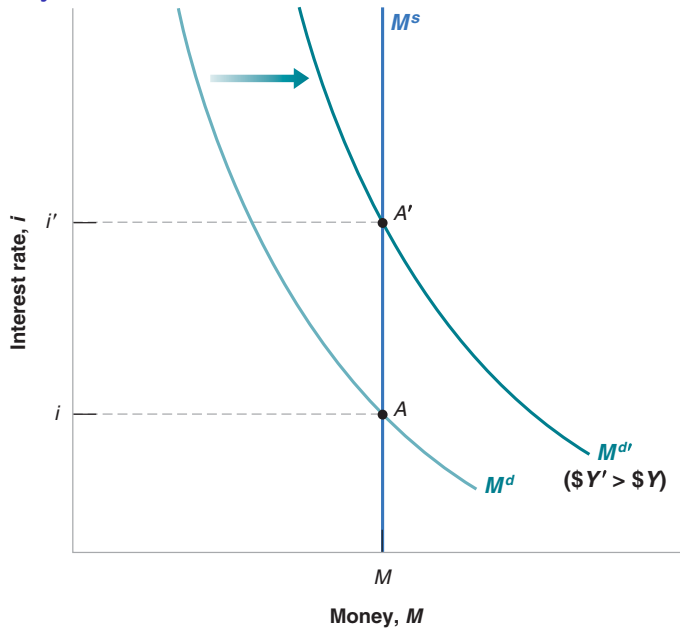
Money market clearing:

$$M^s = \$YL(i) \quad (14)$$

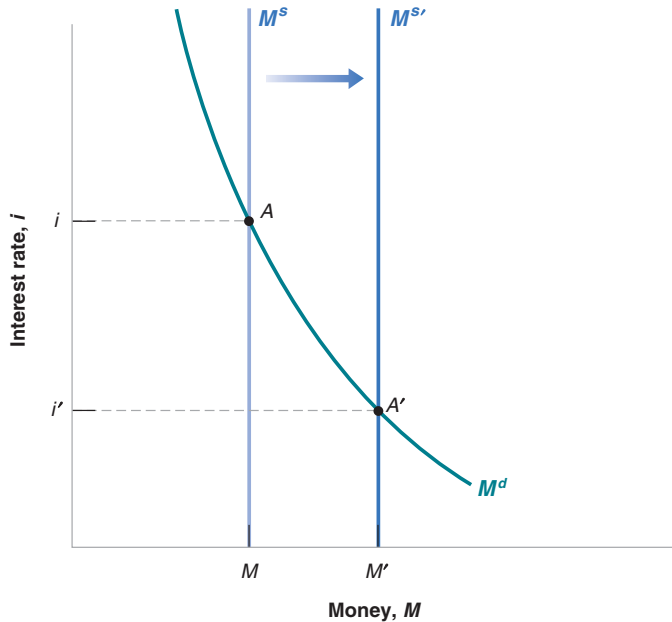
Money Market Clearing



Money Demand Increases



Money Supply Increases



Open Market Operations

- ▶ The markets for money and bonds are linked.
- ▶ To increase the money supply, the CB buy bonds and pays with currency.
- ▶ The price of bonds rises \implies the bond yield i falls.
- ▶ A complication: the CB has no direct control over the supply of bonds / the bond interest rate.
 - ▶ open market operations do not always work

Reading

- ▶ Blanchard / Johnson, Macroeconomics, ch. 3-4