IS-LM: Further analysis

EC 235 | Fall 2023

Required readings:

- Blanchard, ch. 5.

After setting up the *IS* and *LM* schedules and their *interaction*, we move on to analyzing the effects of *economic policy* on the *goods* and *money* markets.

We begin by looking at the *money market*.

More specifically, how does *monetary policy* affect the level of *output* (income) and the *interest rate*?

Let us consider an increase in the *money supply* (M^S).

Now, let us look at the *goods market*.

More specifically, how does *fiscal policy* affect the level of *output* (income) and the *interest rate*?

Let us consider two cases:

1. An increase in *Government expenditures* ($\Delta G > 0$);
2. An increase in *Net Taxes* ($\Delta T > 0$).

How *effective* can fiscal and monetary policies be?

In other words, what will be the *size* of the effects on *income* (Y) and on the interest rate (i) of a given change in the policy variable?

In short, the effectiveness of each policy will depend on the *slopes* of the *IS* and *LM* schedules.

In summary...

TABLE 7-2 Monetary and Fiscal Policy Effectiveness and the Slopes of the *IS* and *LM* Schedules

	Monetary Policy	
	IS Schedule	***LM Schedule***
Steep	Ineffective	Effective
Flat	Effective	Ineffective
	Fiscal Policy	
	IS Schedule	***LM Schedule***
Steep	Effective	Ineffective
Flat	Ineffective	Effective