

The IS-LM-PC model: Further analysis

EC 235 | Fall 2023

Materials

Required readings:

- Blanchard, ch. 9.
 - Sections 9–2, 9–3, 9–4, 9–5.

Prologue

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After setting up the IS-LM-PC model, we will analyze a few scenarios from a *graphical* perspective:

- When the economy is *overheating* (actual output is larger than potential output);
- The *zero lower bound*;
- *Fiscal consolidation*;
- *Supply* shocks.

Short- and medium-run equilibria

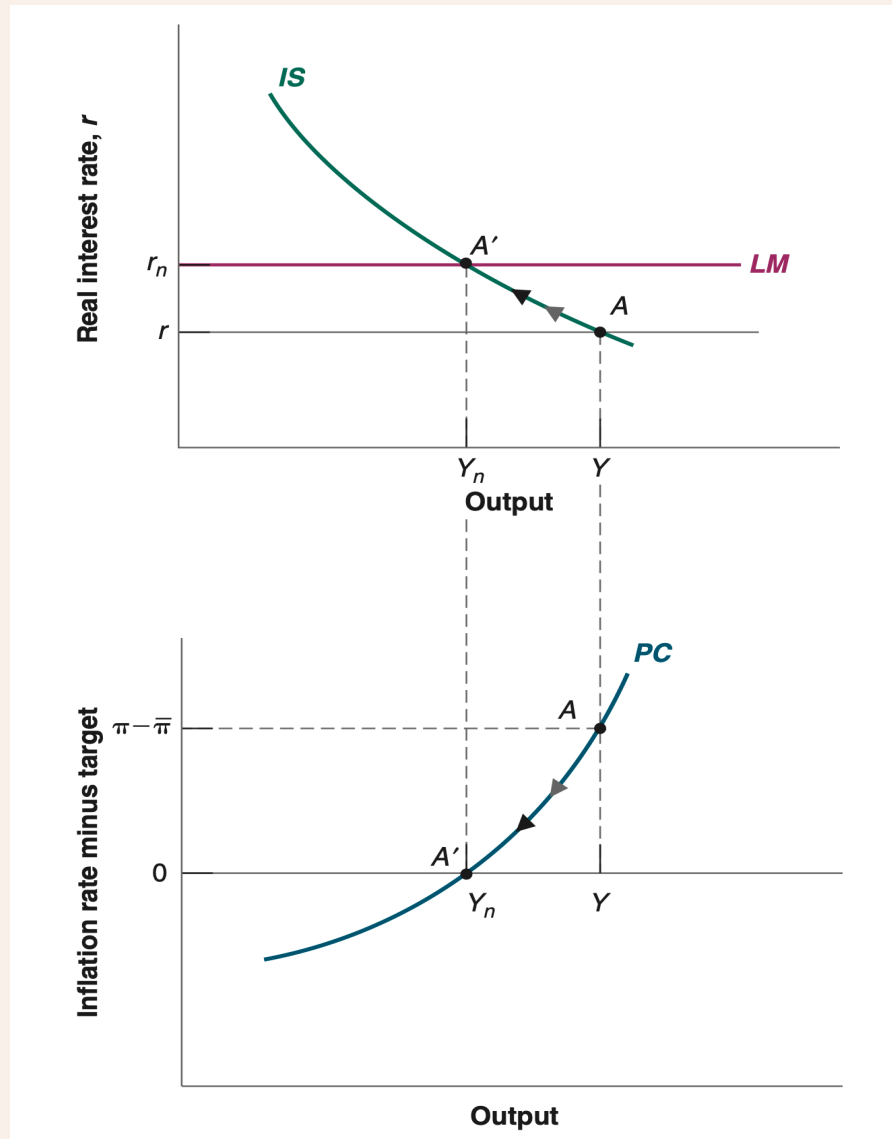
Short- and medium-run equilibria

Suppose, for simplicity, a *horizontal LM* curve.

Furthermore, the economy is in an *expansion*, where actual output (Y) is larger than potential (natural) output (Y_n).

What can the *monetary authority* do to control *inflation* and return the economy back to its “natural” level?

Short- and medium-run equilibria



The zero lower bound

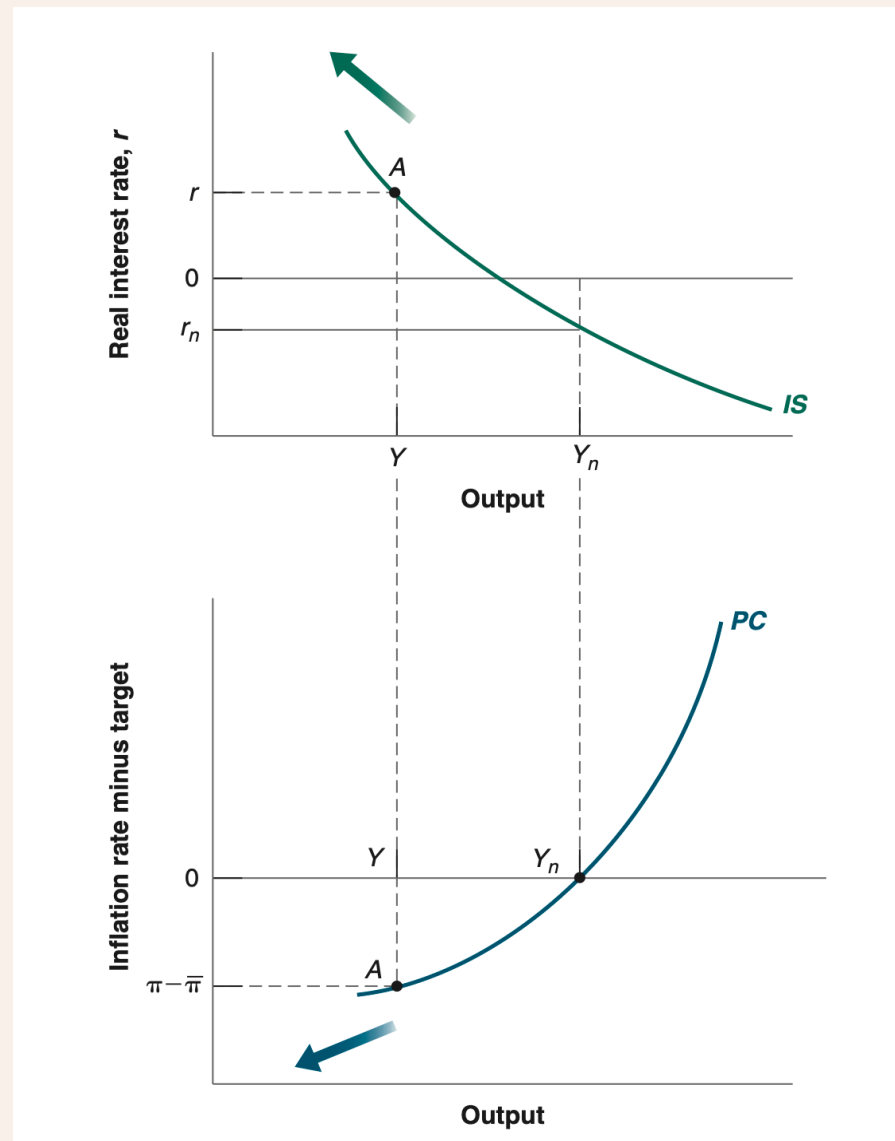
The zero lower bound

Now suppose that the economy is in a *recession*.

This implies that actual output is *below* its potential level.

What can *monetary policy* do?

The zero lower bound



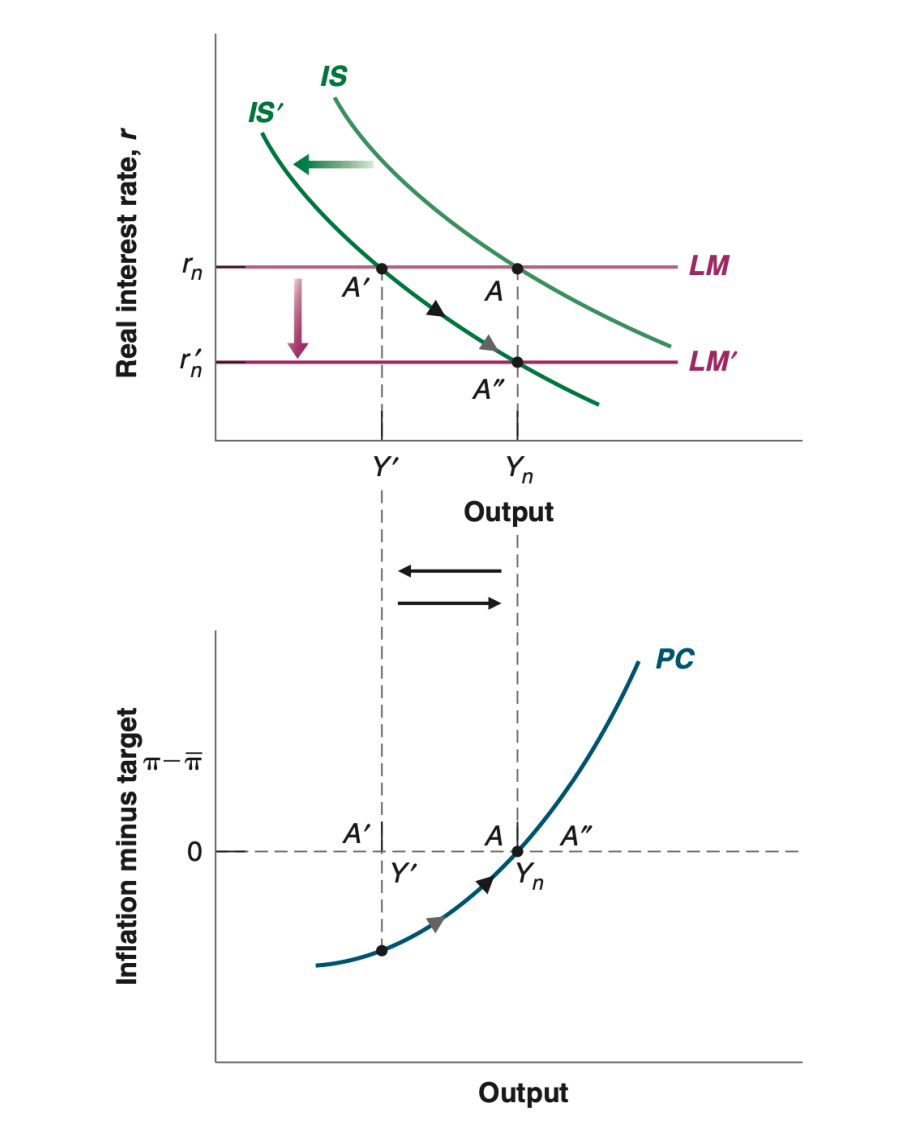
Fiscal consolidation

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We can now assume a situation where the economy is at its “natural” level, and the government wants to *reduce its budget deficit*.

What will be the effects in an *IS-LM-PC* setting?

Fiscal consolidation



Supply shocks

Supply shocks

Lastly, let us study in detail the effects of *supply shocks* to an economy from this perspective.

Supply shocks

