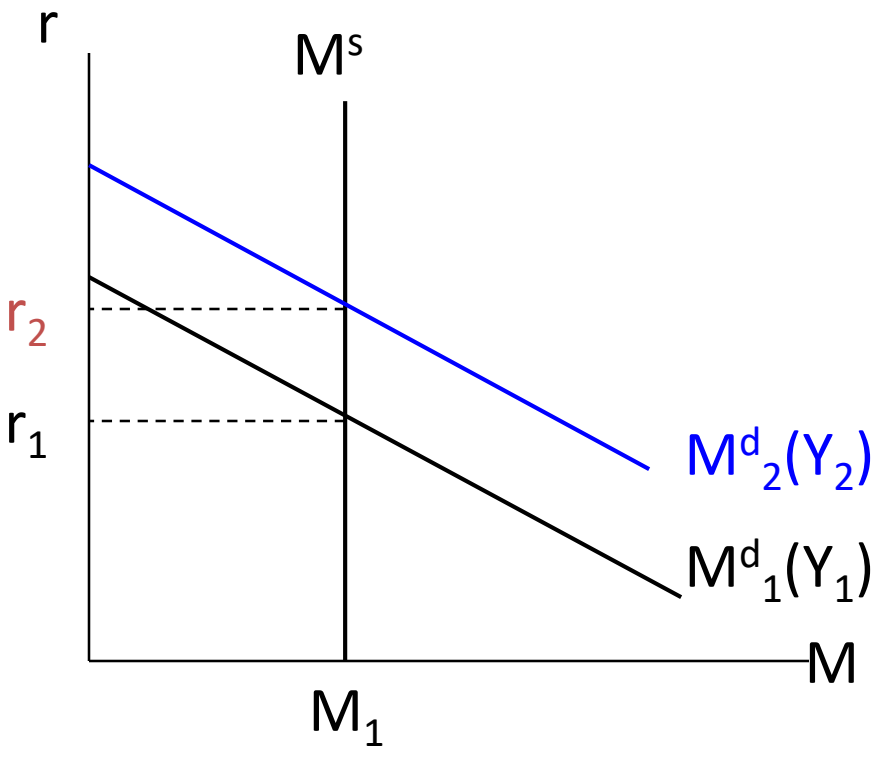
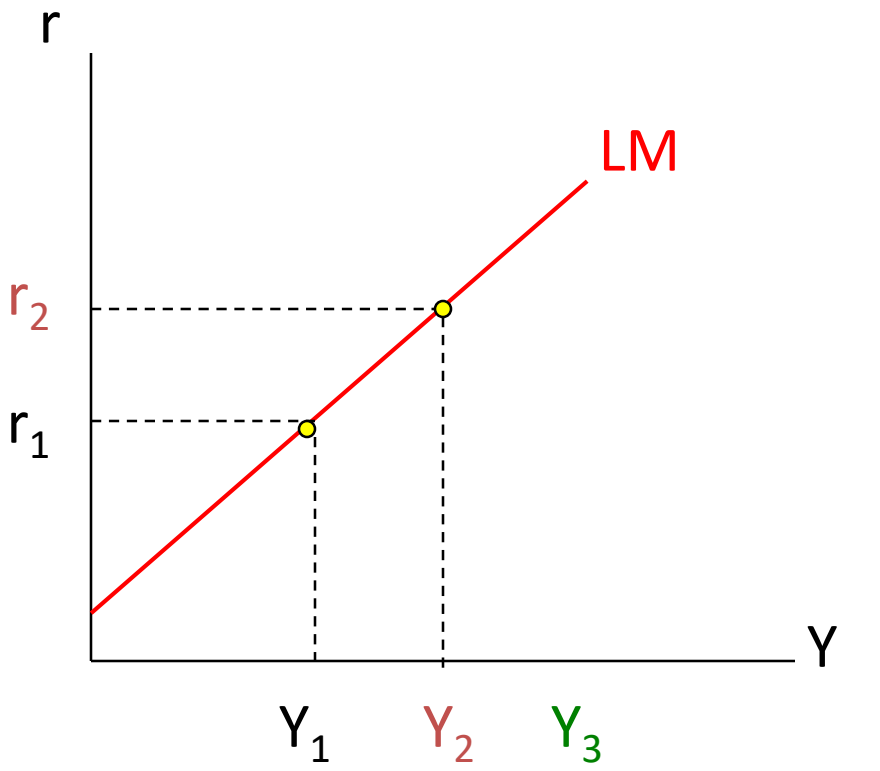
6.2 Money Market and LM Curve

6.2.1 The derivation of LM Curve

Equi^{m} money market: $M^d = M^s$ ⇨ **Find relationship between r and Y**





Y↑ ⇨ M^d ↑ (M^d shifts to the right) ⇨ r ↑ from r_1 to r_2

∴ Y↑ ➡ r ↑

6.2.2 Factors determining slope of LM curve

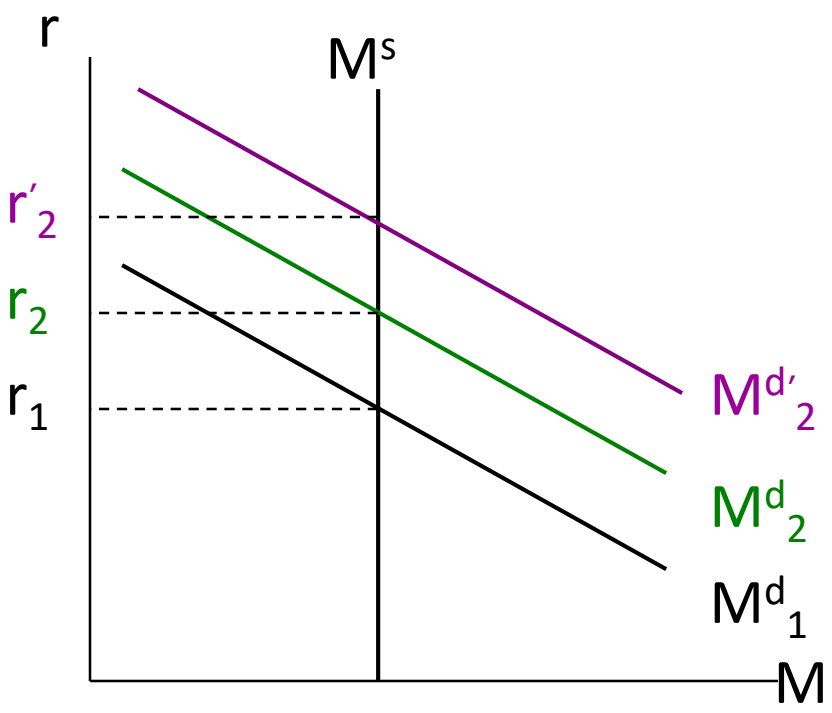
1. The response of people in terms of changes in money demand (M^d) when national income (Y) changes

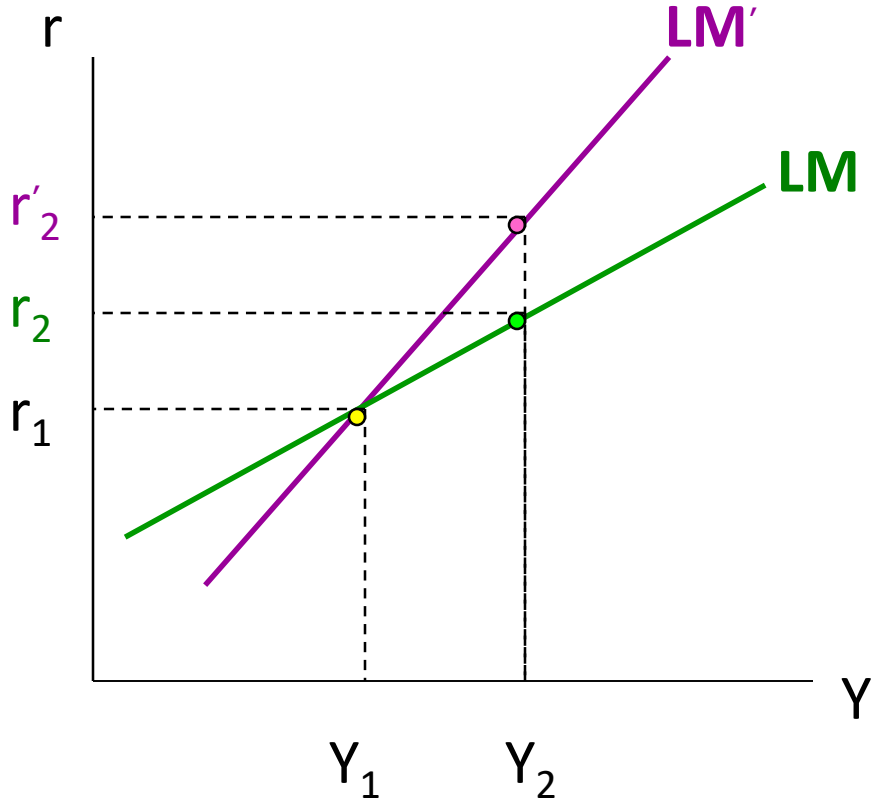
$$\frac{\Delta M^d}{\Delta Y}$$

2. The response of people in terms of changes in money demand (M^d) when real interest rate (r) changes

$$\frac{\Delta M^d}{\Delta r}$$

Factors determining slope of LM curve : $\frac{\Delta M^d}{\Delta Y}$





Factors determining slope of LM curve : $\frac{\Delta M^d}{\Delta Y}$

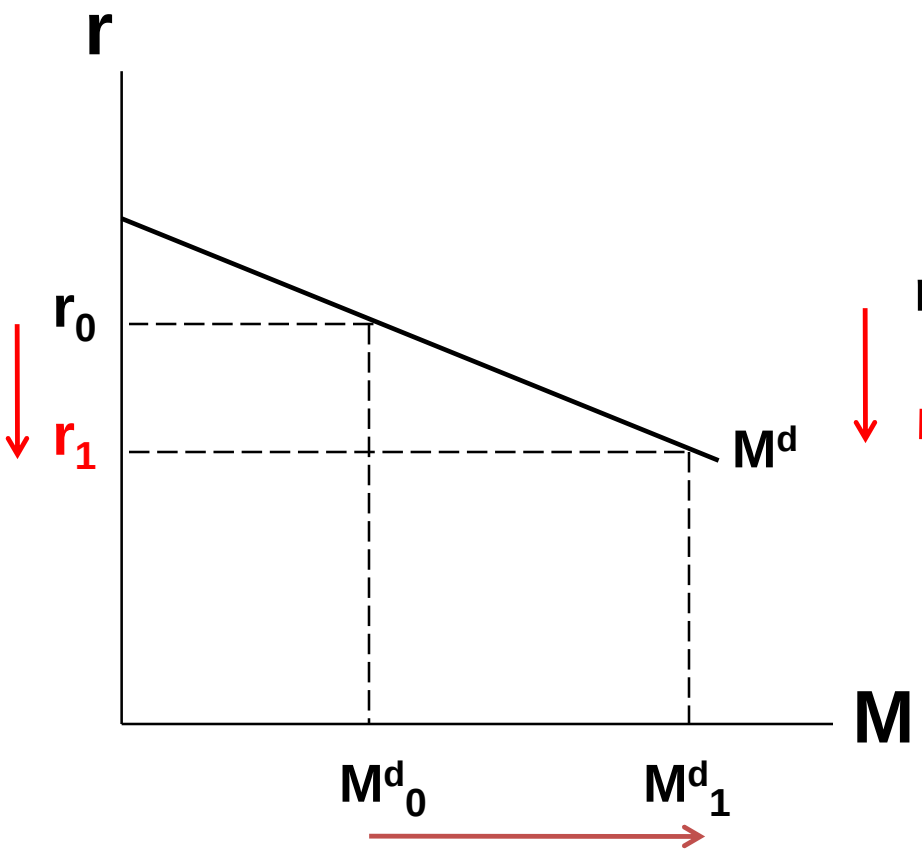
- ∴ If $\frac{\Delta M^d}{\Delta Y}$ high ⇒ when Y↑ ⇒ M^d↑ a lot

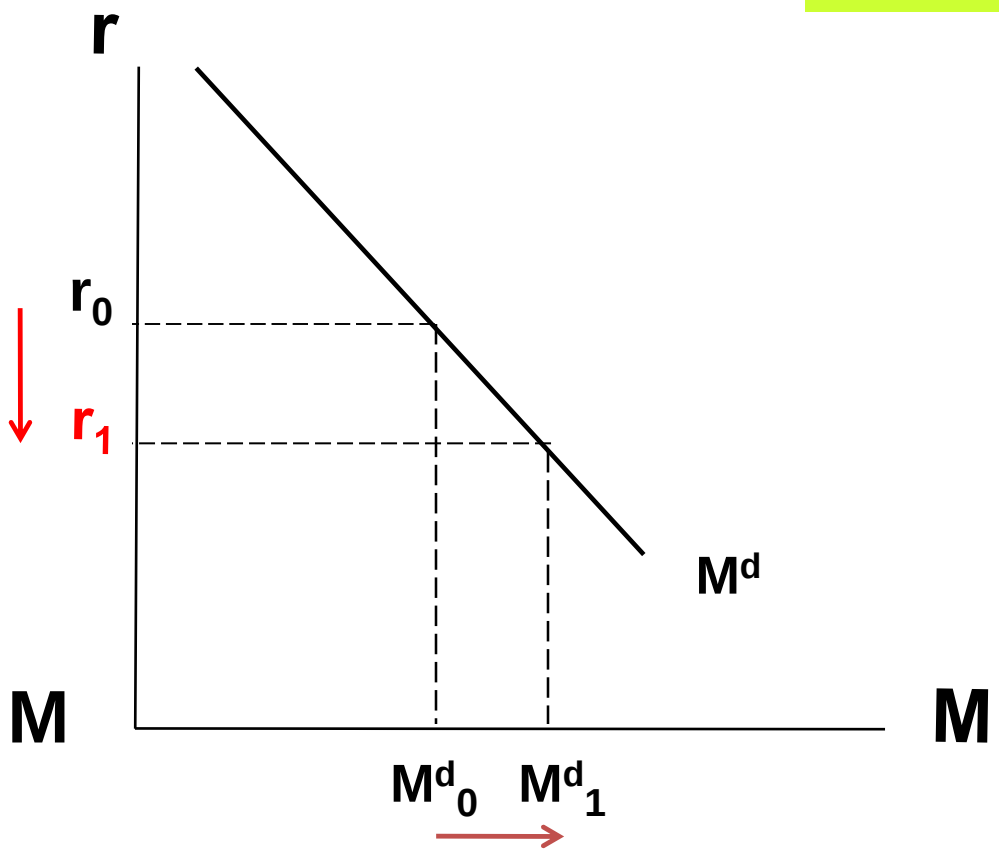
  ⇒ r↑ a lot ⇒ LM quite steep (LM')

- ∴ If $\frac{\Delta M^d}{\Delta Y}$ low ⇒ when Y↑ ⇒ M^d↑ a little

  ⇒ r↑ a little ⇒ LM quite flat (LM)

Factors determining slope of LM curve : $\frac{\Delta M^d}{\Delta r}$





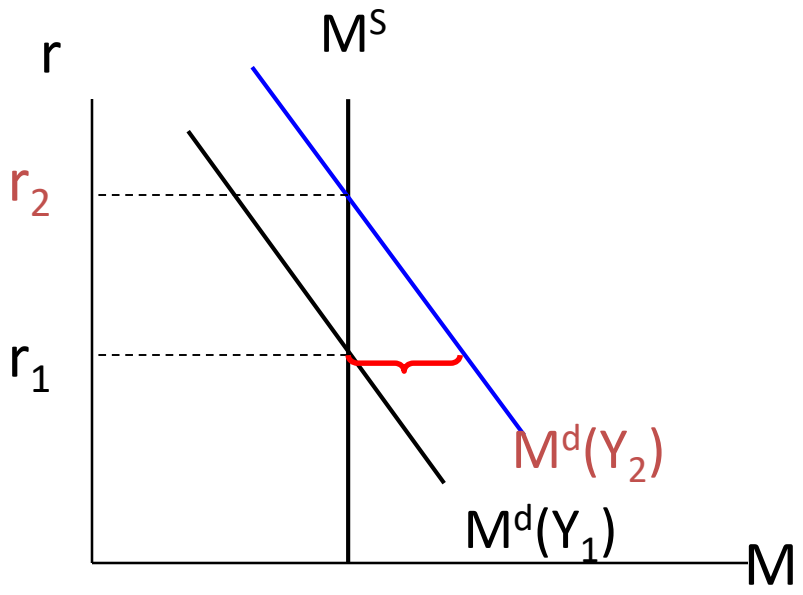
When r ↓ ➡ M^d ↑ a lot

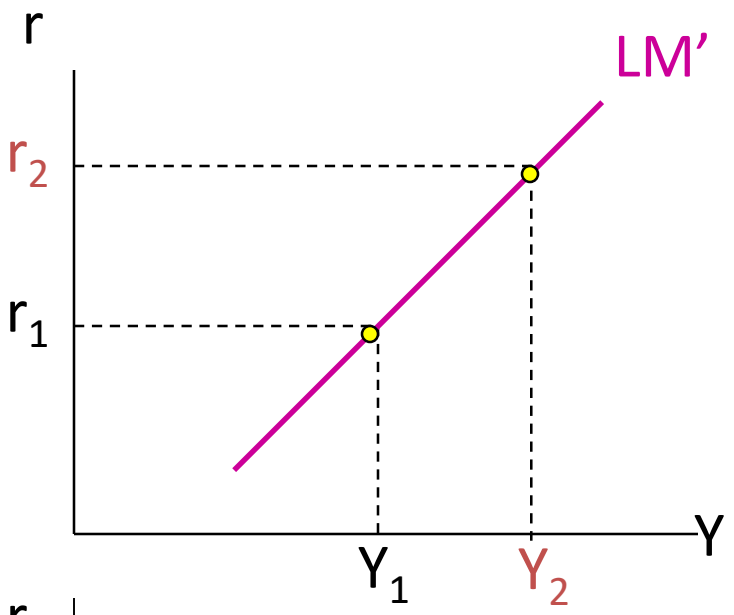
$\left(\frac{\Delta M^d}{\Delta r}\right)$ is high

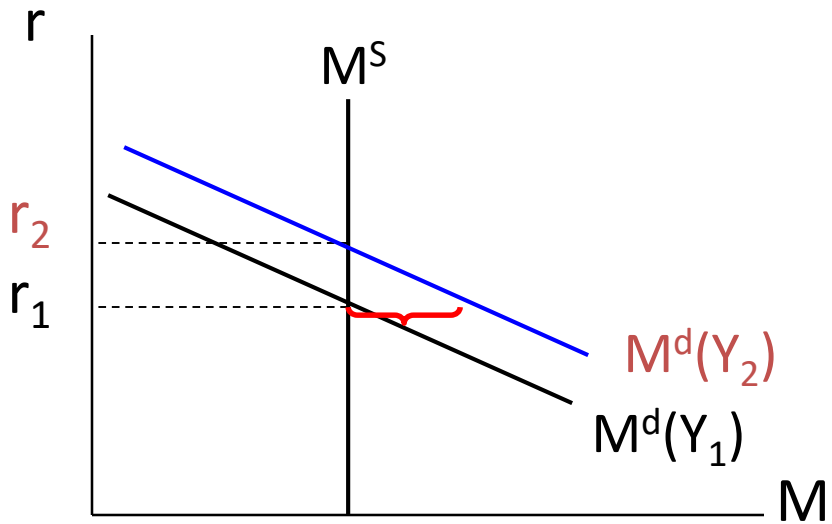
When r ↓ ➡ M^d ↑ a little

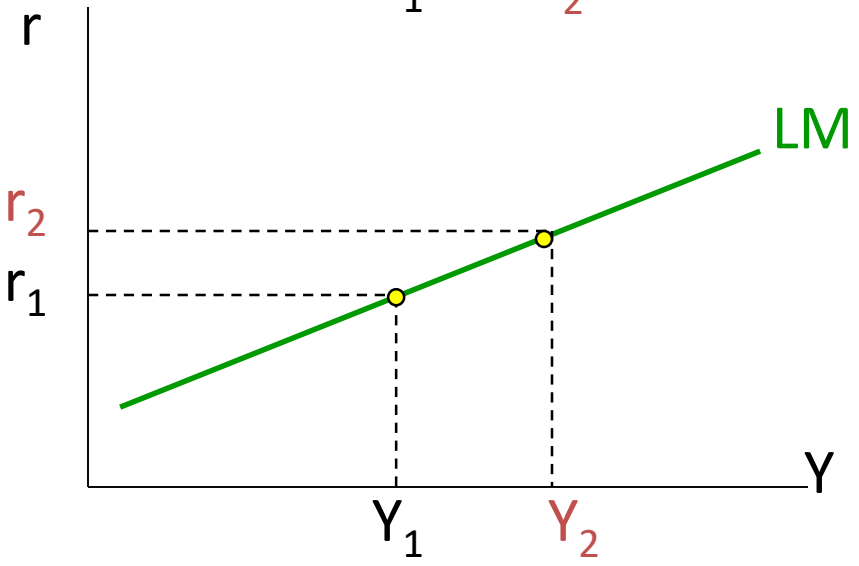
$\left(\frac{\Delta M^d}{\Delta r}\right)$ is low

Factors determining slope of LM curve : $\frac{\Delta M^d}{\Delta r}$









Factors determining slope of LM curve : $\frac{\Delta M^d}{\Delta r}$

Elasticity of M^d for changes in **r** ⇒ $\varepsilon_{M^d,r} = \frac{\Delta M^d}{\Delta r} \times \frac{r}{M^d}$

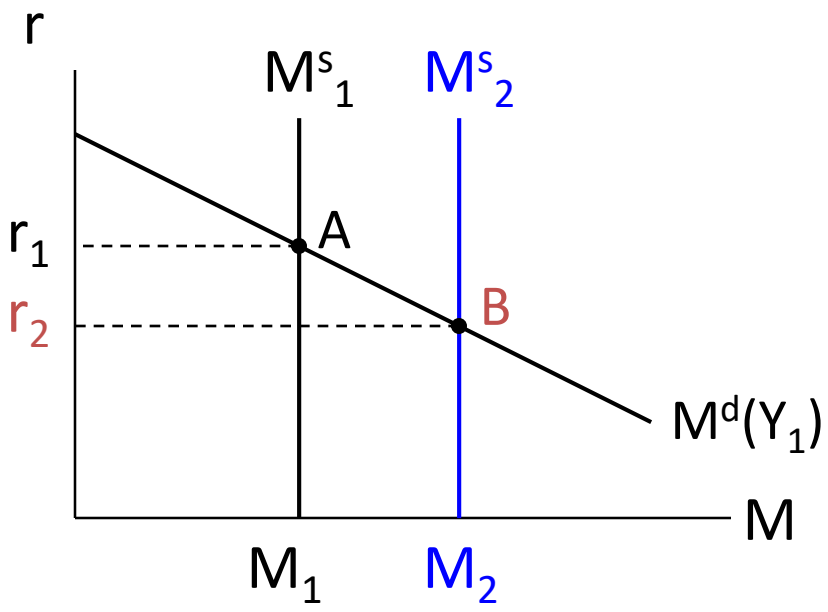
$\varepsilon_{M^d,r}$ **low** ⇒ M^d **line quite steep** ⇒ **LM quite steep (LM')**

$\varepsilon_{M^d,r}$ **high** ⇒ M^d **line quite flat** ⇒ **LM quite flat (LM)**

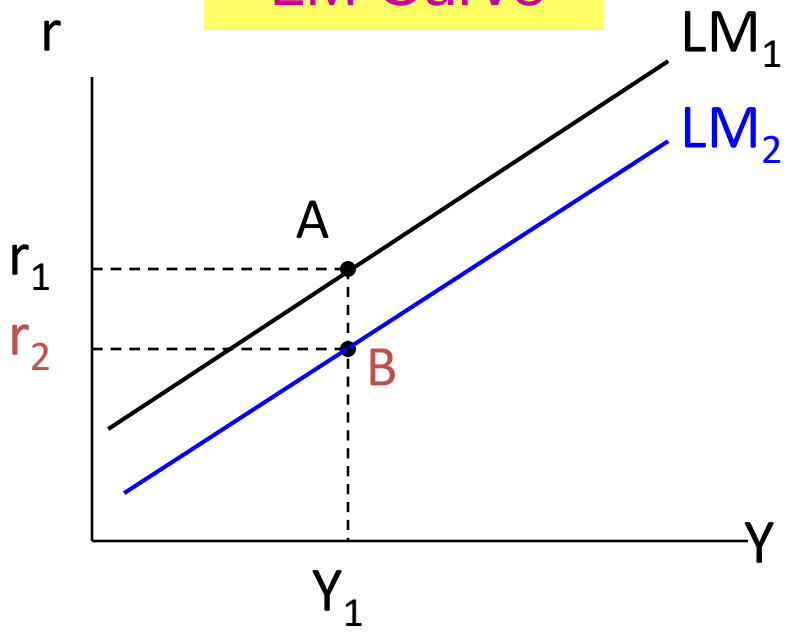
6.2.3 Shifts in LM curve

Eg. From changes in M^s

Money Market



LM Curve

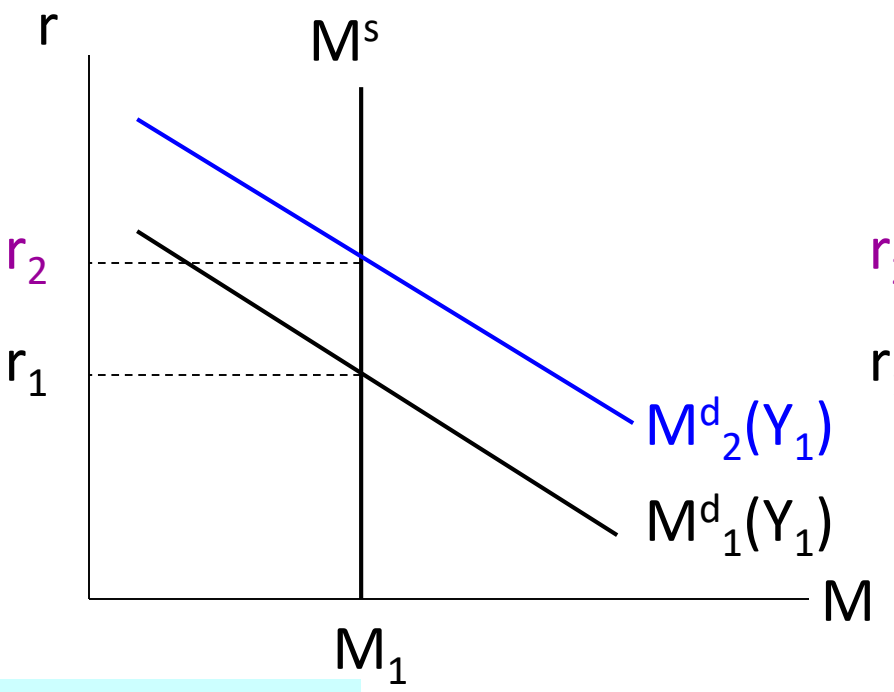


$M^s\uparrow$ ⇨ **$r\downarrow$** ⇨ **LM shifts to the right**

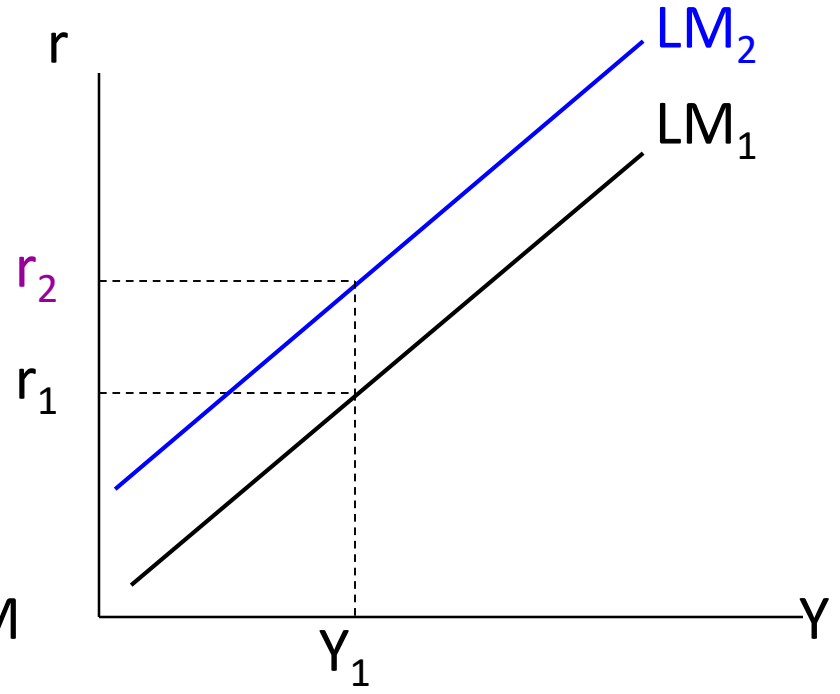
6.2.3 Shifts in LM curve

Eg. From changes in M^d (which is not from changes in Y and r)

Money Market



LM Curve



People change habit to hold more money → M^d ↑ (M^d shifts to the right) → r ↑ → LM shifts to the left