

IS-LM Model

A Case of Closed Economy with Constant Prices

6.1 Product Market and IS Curve

6.1.1 Investment, interest rate, and Product Market Equilibrium

• $I = f(r, Y)$, $r \uparrow \Rightarrow I \downarrow$ Investment is negatively related to real interest rate

• Equilibrium in product market occurs when

With government

1)

2)

Without government

6.1.2 The derivation of IS curve

- Derivation of IS Curve



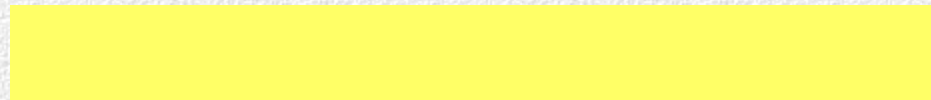
Use $Y = DAE$ approach

- Use relationship between r , I , Y

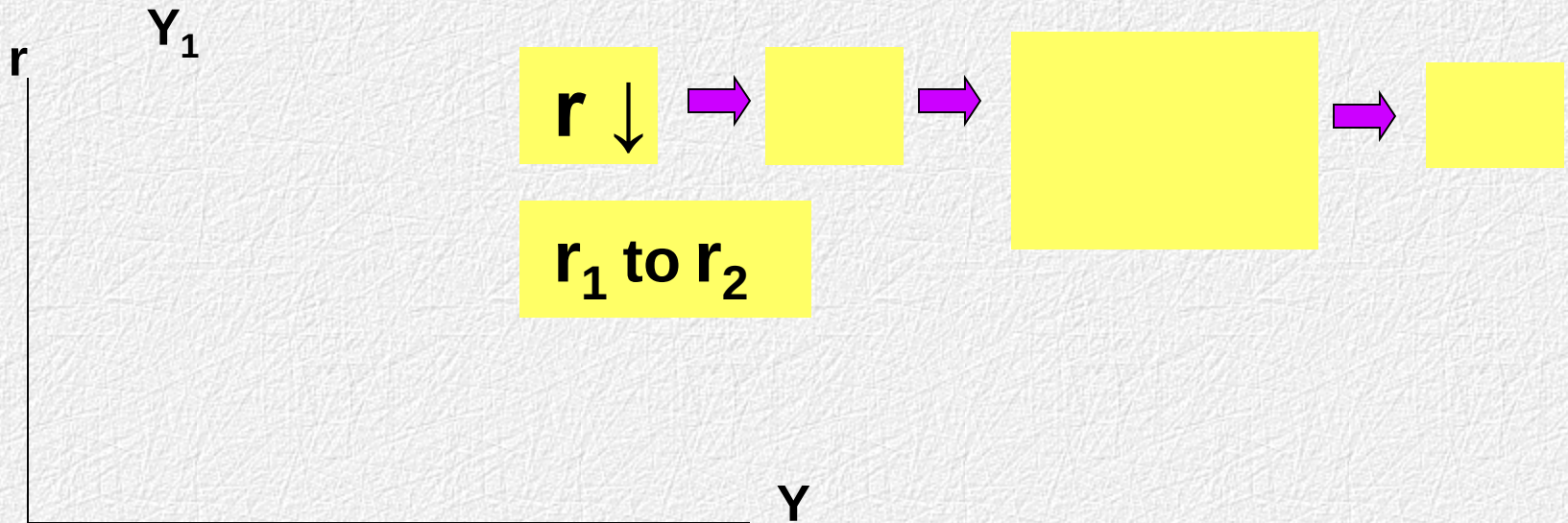
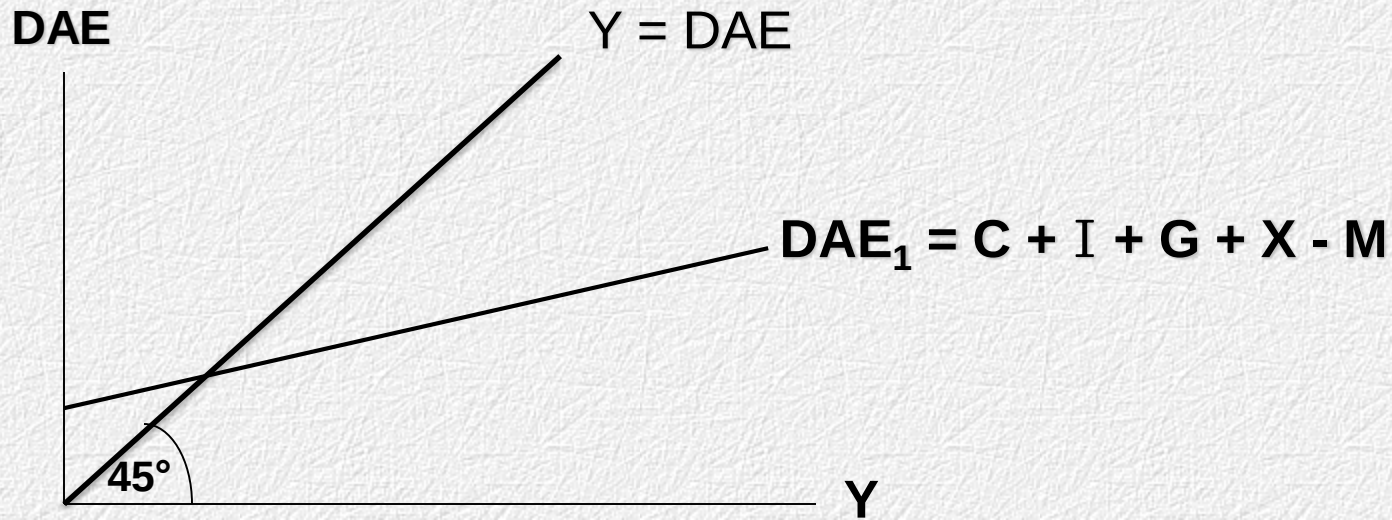
- $r \uparrow$



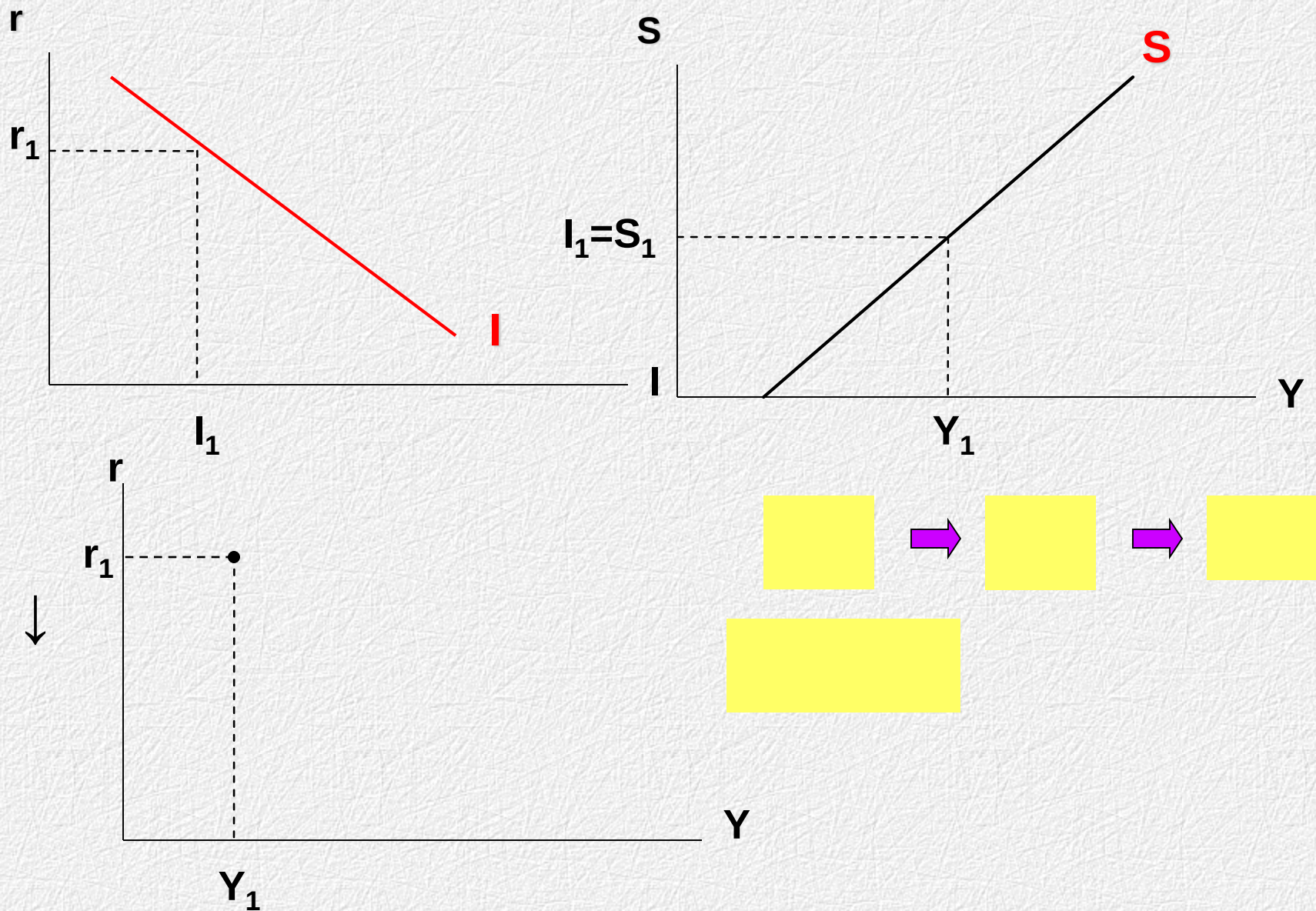
- $r \downarrow$



The derivation of IS curve



The derivation of IS curve (Injection = leakage approach)



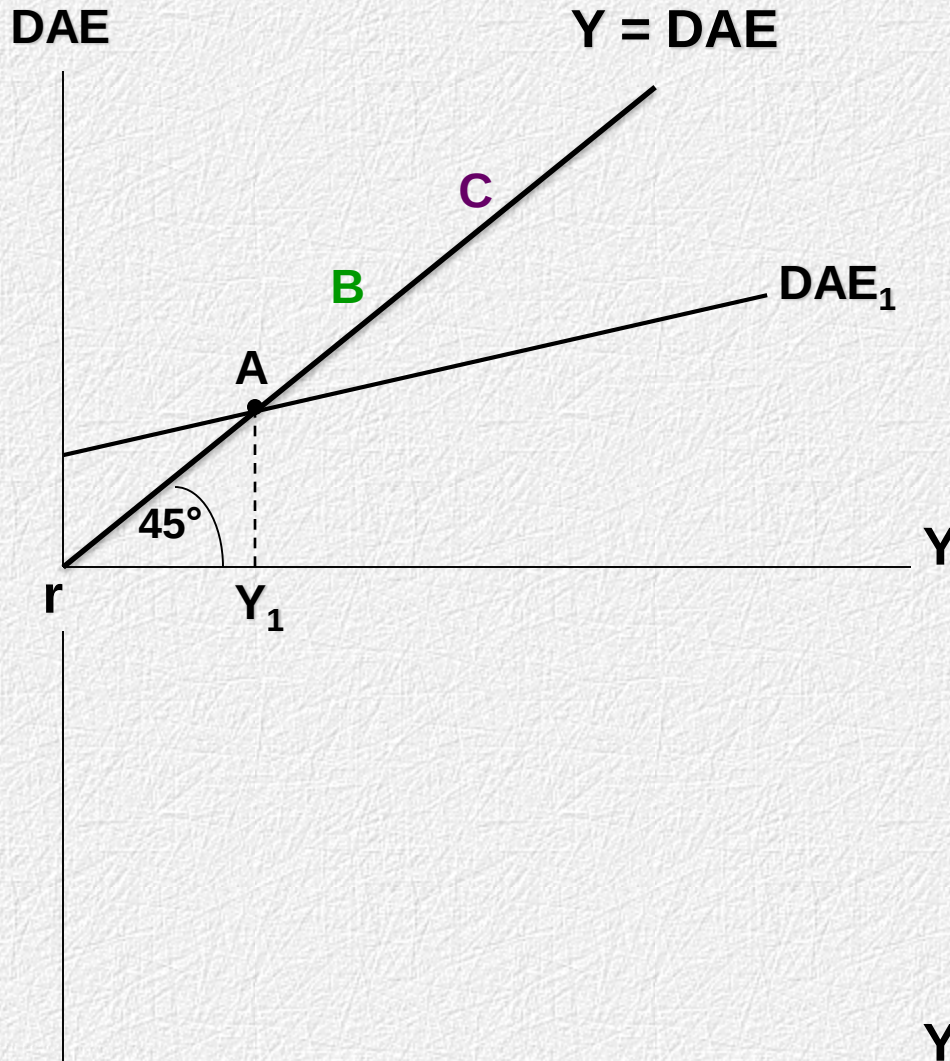
6.1.3 Factors determining slope of IS curve

- Changes in investment when real interest rate change

$$\left(\frac{\Delta I}{\Delta r} \right)$$

- Size of Expenditure Multiplier

Factors determining slope of IS curve

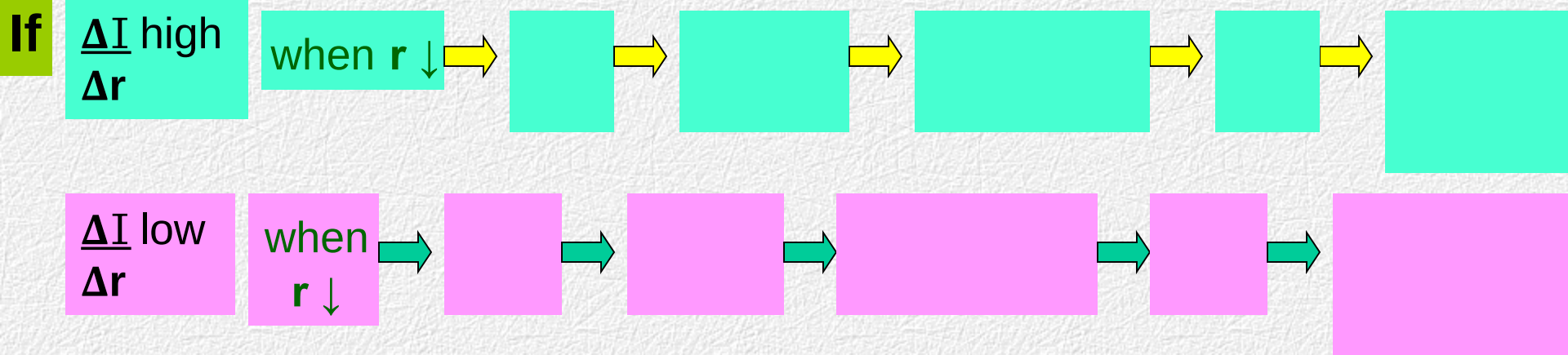


High $\frac{\Delta I}{\Delta r}$,

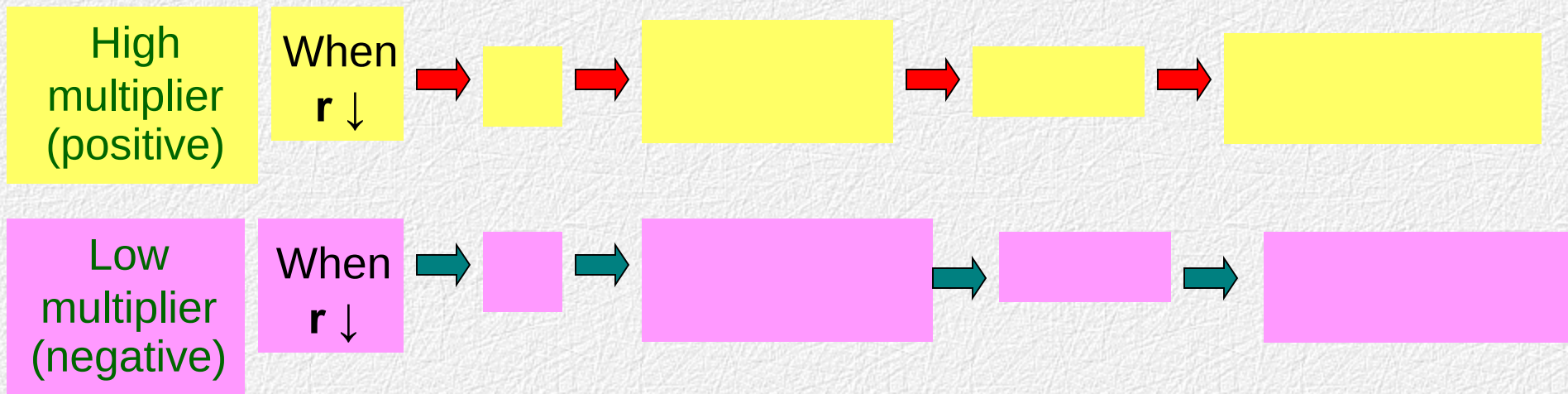
High Expenditure Multiplier

Factors determining slope of IS curve

- Changes in investment when real interest rate change



- Size of Expenditure Multiplier



6.1.4 Shifts in IS Curve

Equilibrium

$$Y = DAE = C + I + G + X - M \quad - \quad I + G + X = S + T + M$$

$$I = I(r)$$

$$S = S(Y^d)$$

Shift of the **IS curve** occurs from Δ of any variable (except r) that determine **DAE**. For example

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6.1.4 Shifts in IS Curve

Equilibrium

$$Y = DAE = C + I + G$$

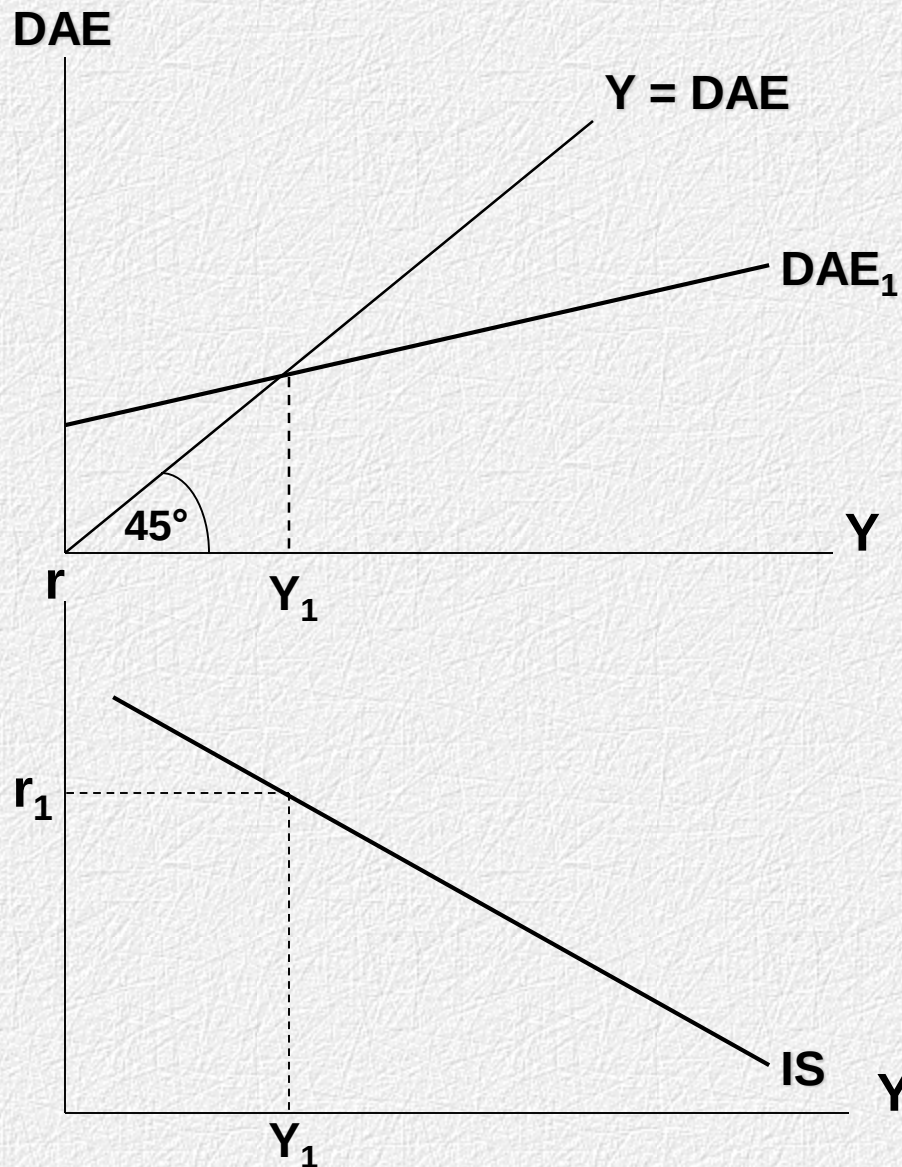
$$I + G = S + T$$

$$I = I(r) \quad , \quad S = S(Y^d)$$

Shift of the **IS curve** occurs from Δ of any variable (except r) that determine **DAE**. For example

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Shifts in IS Curve



• If $G \uparrow$



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