Chapter 11

Aggregate Demand I: Building the *IS-LM* Model

11

Aggregate Demand I: Building the *IS-LM* Model

MACROECONOMICS

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IN THIS CHAPTER, YOU WILL LEARN:

- the *IS* curve and its relation to:
  - the Keynesian cross
  - the loanable funds model
- the *LM* curve and its relation to:
  - the theory of liquidity preference
- how the *IS*-*LM* model determines income and the interest rate in the short run when ***P*** is fixed

Context

- Chapter 10 introduced the model of aggregate demand and aggregate supply.
- ***Long run:***
  - prices flexible
  - output determined by factors of production & technology
  - unemployment equals its natural rate
- ***Short run:***
  - prices fixed
  - output determined by aggregate demand
  - unemployment negatively related to output

Context

- This chapter develops the *IS-LM* model, the basis of the aggregate demand curve.
- We focus on the short run and assume the price level is fixed (so the *SRAS* curve is horizontal).
- Chapters 11 and 12 focus on the closed-economy case. Chapter 13 presents the open-economy case.

The Keynesian cross

- A simple closed-economy model in which income is determined by expenditure.
  (due to J. M. Keynes)
- Notation:

  I = planned investment

  $PE = C + I + G$ = planned expenditure

  Y = real GDP = actual expenditure
- Difference between actual & planned expenditure = unplanned inventory investment

Elements of the Keynesian cross

consumption function: $C = C(Y - T)$

govt policy variables: $G = \bar{G}, \quad T = \bar{T}$

for now, planned investment is exogenous: $I = \bar{I}$

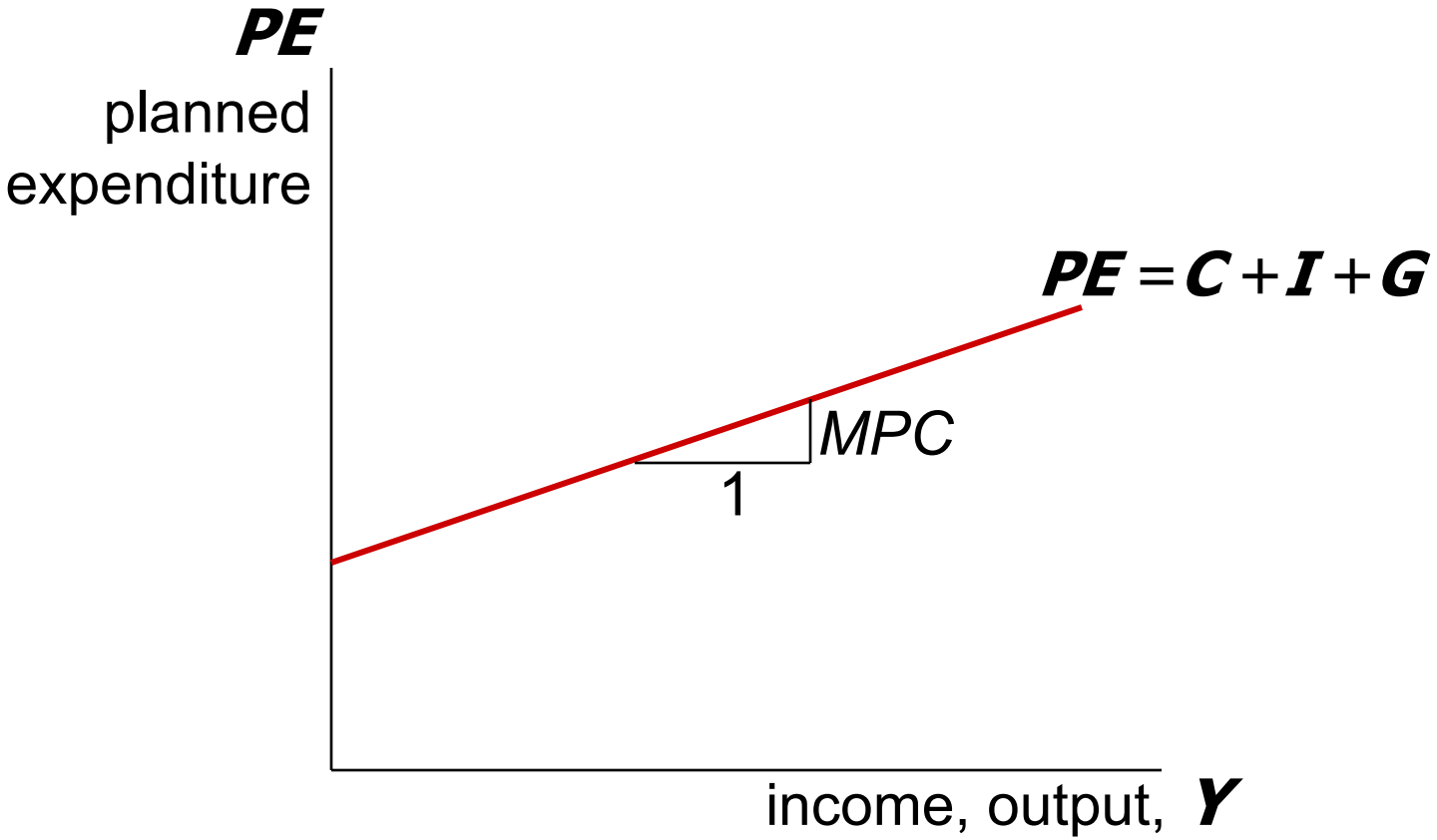
planned expenditure: $PE = C(Y - \bar{T}) + \bar{I} + \bar{G}$

equilibrium condition:

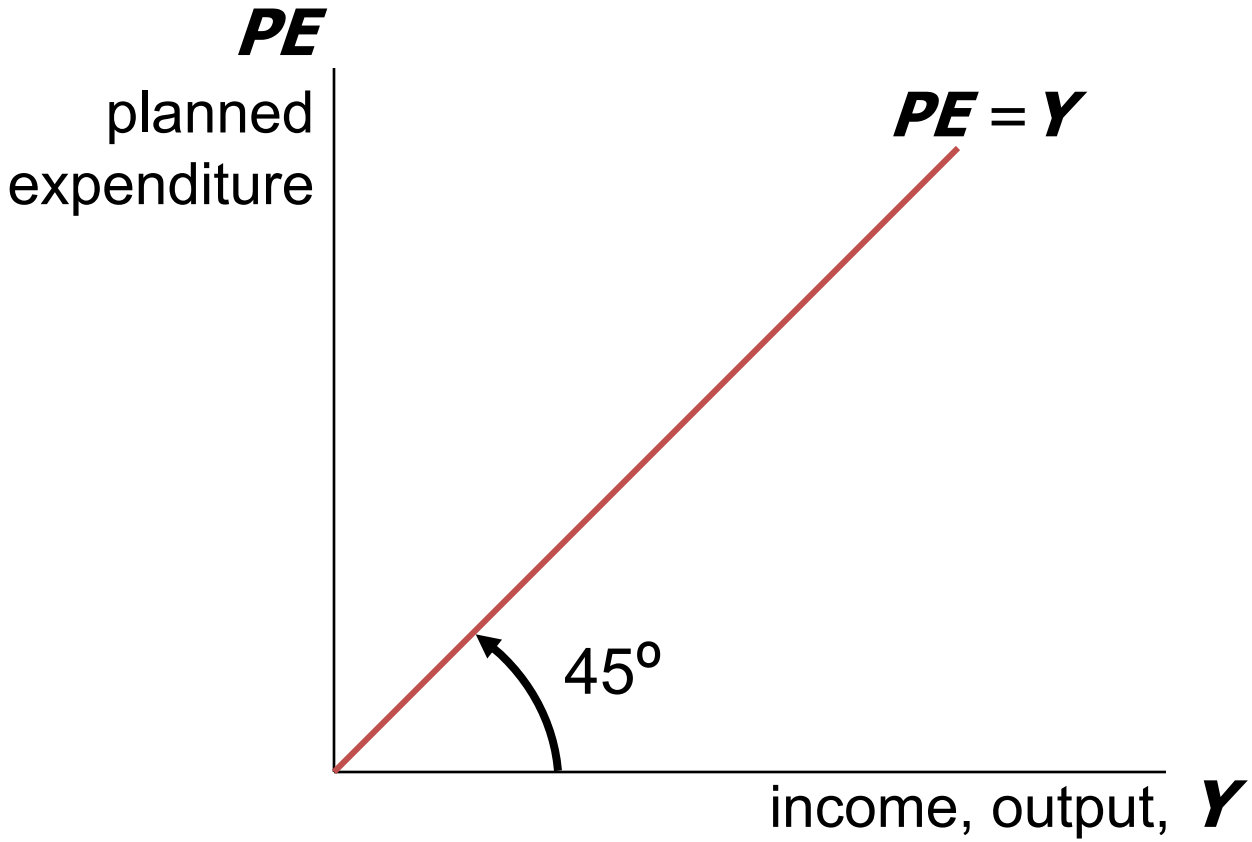
actual expenditure = planned expenditure

$$Y = PE$$

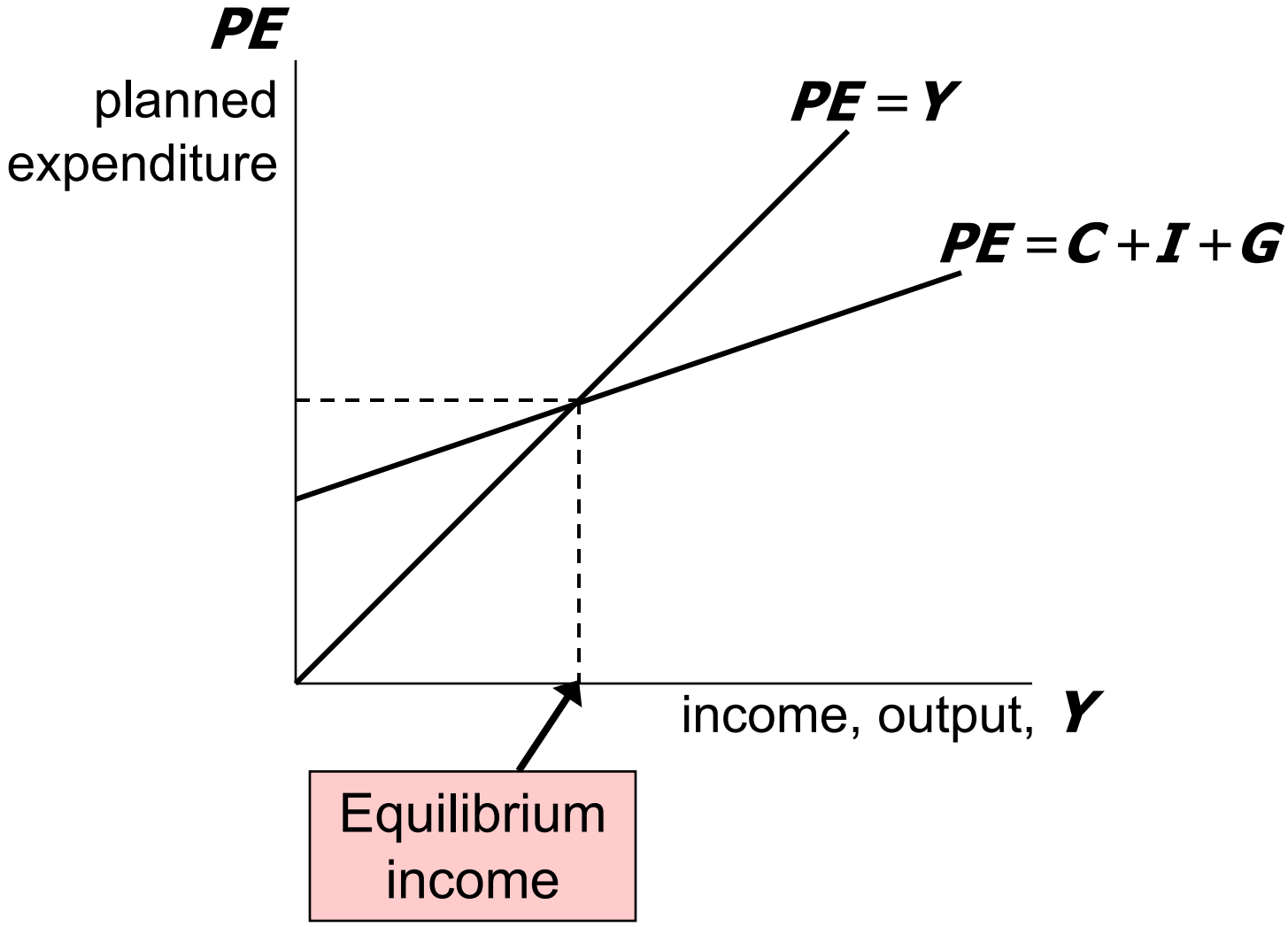
Graphing planned expenditure



Graphing the equilibrium condition



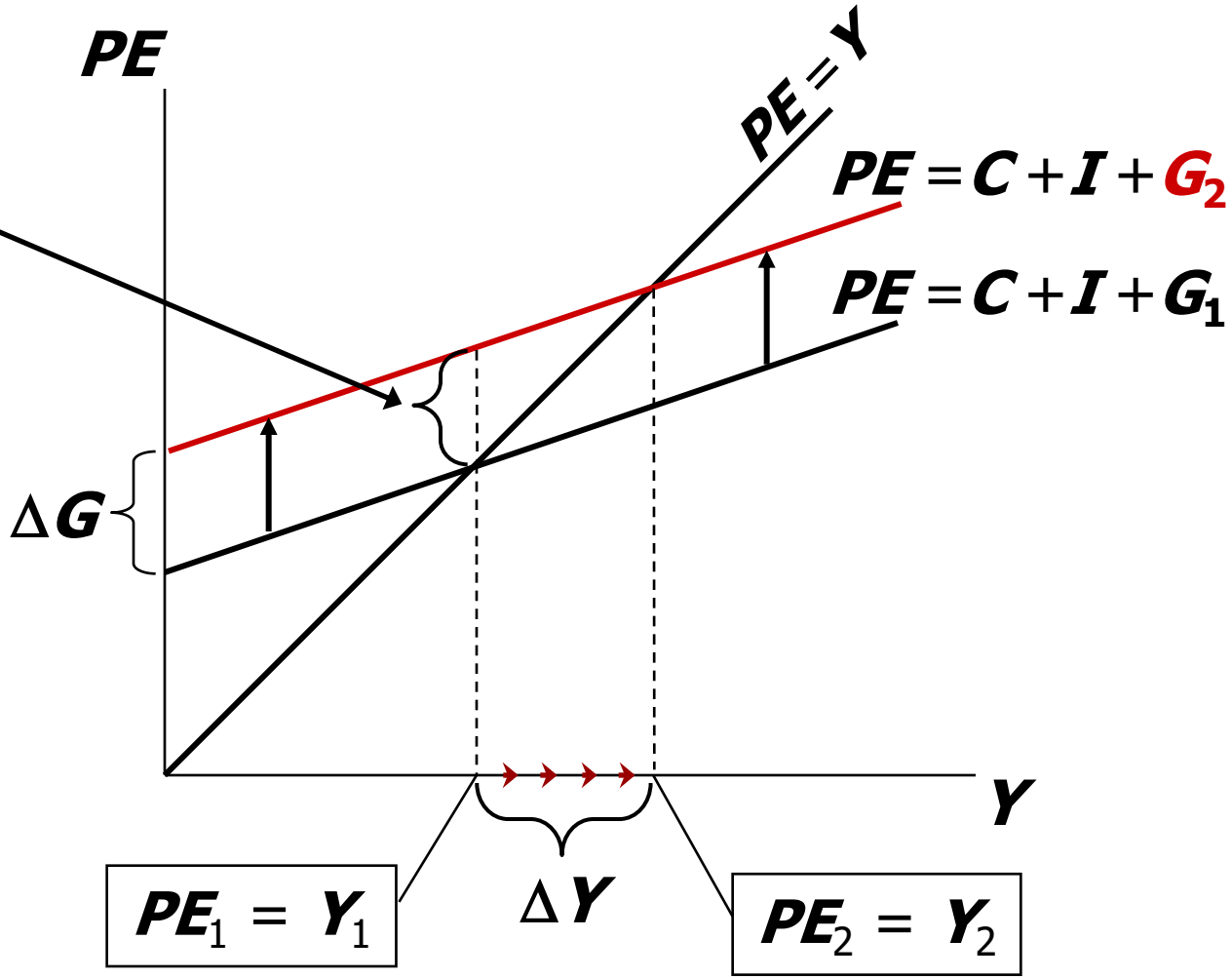
The equilibrium value of income



An increase in government purchases

At Y_1,
there is now an unplanned drop in inventory…

…so firms increase output, and income rises toward a new equilibrium.



Marginal Propensity to Consume

- How big is the multiplier effect?
  It depends on how much consumers respond to increases in income.
- **Marginal propensity to consume (MPC)**: the fraction of extra income that households consume rather than save

  E.g., if *MPC* = 0.8 and income rises \$100, ***C*** rises \$80.

Solving for ΔY

$$Y = C + I + G$$ equilibrium condition

$$\Delta Y = \Delta C + \Delta I + \Delta G$$ in changes

$$= \Delta C + \Delta G$$ because I exogenous

$$= \text{MPC} \times \Delta Y + \Delta G$$ because $\Delta C = \text{MPC}\,\Delta Y$

Collect terms with ΔY on the left side of the equals sign:

$$(1 - \text{MPC}) \times \Delta Y = \Delta G$$

Solve for ΔY:

$$\Delta Y = \left(\frac{1}{1 - \text{MPC}} \right) \times \Delta G$$

A Formula for the Multiplier

The size of the multiplier depends on *MPC*.

E.g., if *MPC* = 0.5 multiplier = 2
if *MPC* = 0.75 multiplier = 4
if *MPC* = 0.9 multiplier = 10

$$\Delta Y = \frac{1}{1 - MPC} \Delta G$$

The multiplier

A bigger *MPC* means changes in ***Y*** cause bigger changes in ***C***, which in turn cause more changes in ***Y***.

The government purchases multiplier

Definition: the increase in income resulting from a \$1 increase in ***G***.

In this model, the govt purchases multiplier equals

$$\frac{\Delta \boldsymbol{Y}}{\Delta \boldsymbol{G}} = \frac{1}{1 - \text{MPC}}$$

Example: If *MPC* = 0.8, then

$$\frac{\Delta \boldsymbol{Y}}{\Delta \boldsymbol{G}} = \frac{1}{1 - 0.8} = 5$$

An increase in ***G*** causes income to increase 5 times as much!

Why the multiplier is greater than 1

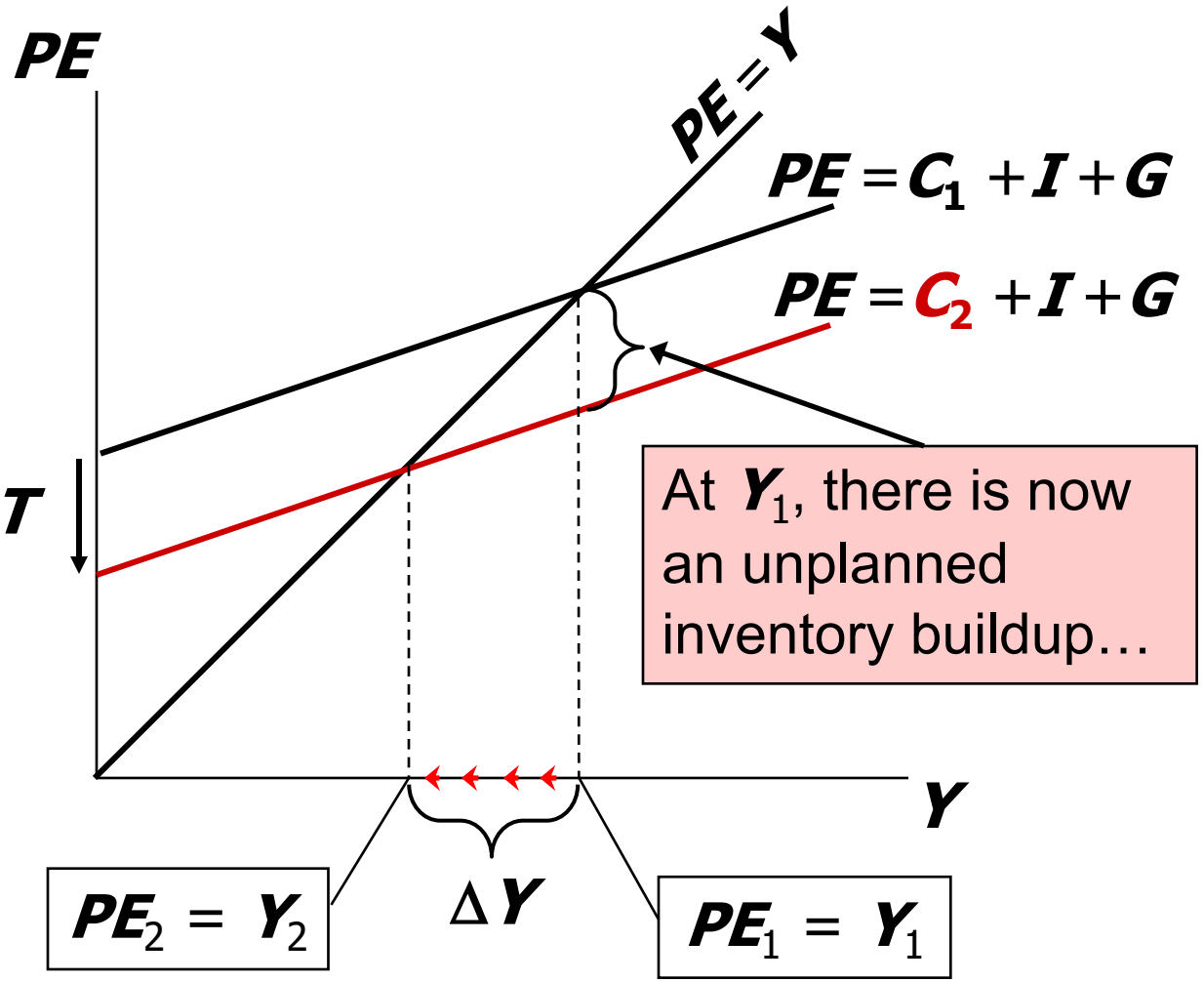
- Initially, the increase in ***G*** causes an equal increase in ***Y:*** $\Delta Y = \Delta G$.
- But $\uparrow Y \Rightarrow \uparrow C$
  $\Rightarrow$ further $\uparrow Y$
  $\Rightarrow$ further $\uparrow C$
  $\Rightarrow$ further $\uparrow Y$
- So the final impact on income is much bigger than the initial ΔG.

An increase in taxes

Initially, the tax increase reduces consumption and therefore ***PE***:

$\Delta C = -\text{MPC}\,\Delta T$

…so firms reduce output, and income falls toward a new equilibrium



At Y_1, there is now an unplanned inventory buildup…

Solving for ΔY

$$\Delta \boldsymbol{Y} = \Delta \boldsymbol{C} + \Delta \boldsymbol{I} + \Delta \boldsymbol{G}$$

eq'm condition in changes

$$= \Delta \boldsymbol{C}$$

I and ***G*** exogenous

$$= \text{MPC} \times \left(\Delta \boldsymbol{Y} - \Delta \boldsymbol{T} \right)$$

Solving for $\Delta \boldsymbol{Y}$: $\quad (1 - \text{MPC}) \times \Delta \boldsymbol{Y} = -\text{MPC} \times \Delta \boldsymbol{T}$

Final result:

$$\Delta \boldsymbol{Y} = \left(\frac{-\text{MPC}}{1 - \text{MPC}} \right) \times \Delta \boldsymbol{T}$$

The tax multiplier

def: the change in income resulting from a $1 increase in ***T***:

$$\frac{\Delta \boldsymbol{Y}}{\Delta \boldsymbol{T}} = \frac{-\text{MPC}}{1 - \text{MPC}}$$

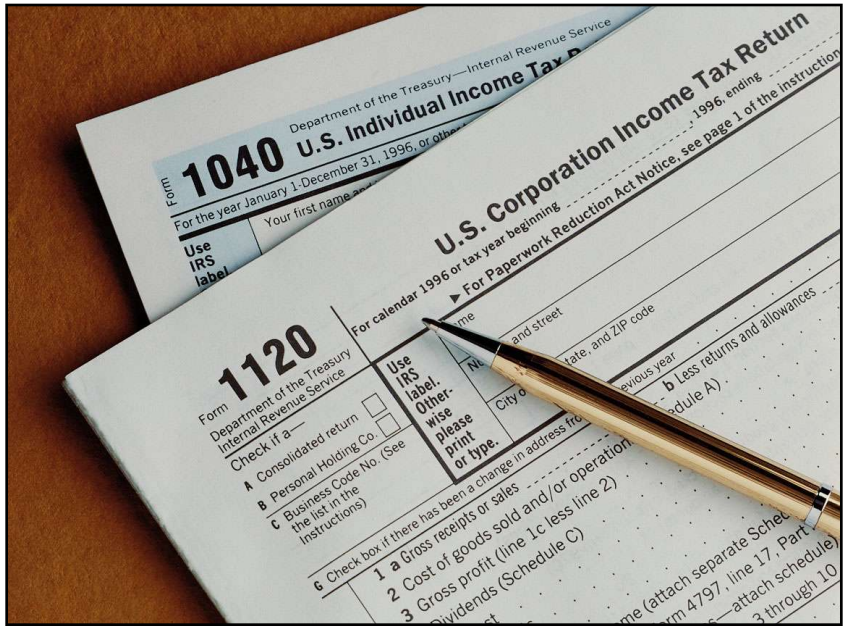
If *MPC* = 0.8, then the tax multiplier equals

$$\frac{\Delta \boldsymbol{Y}}{\Delta \boldsymbol{T}} = \frac{-0.8}{1 - 0.8} = \frac{-0.8}{0.2} = -4$$

The tax multiplier

…is *negative:*
A tax increase reduces ***C***,
which reduces income.

…is *greater than one*
(*in absolute value*):
A change in taxes has a
multiplier effect on income.



…is *smaller than the govt spending multiplier:*
Consumers save the fraction (1 – *MPC*) of a tax cut,
so the initial boost in spending from a tax cut is
smaller than from an equal increase in ***G***.

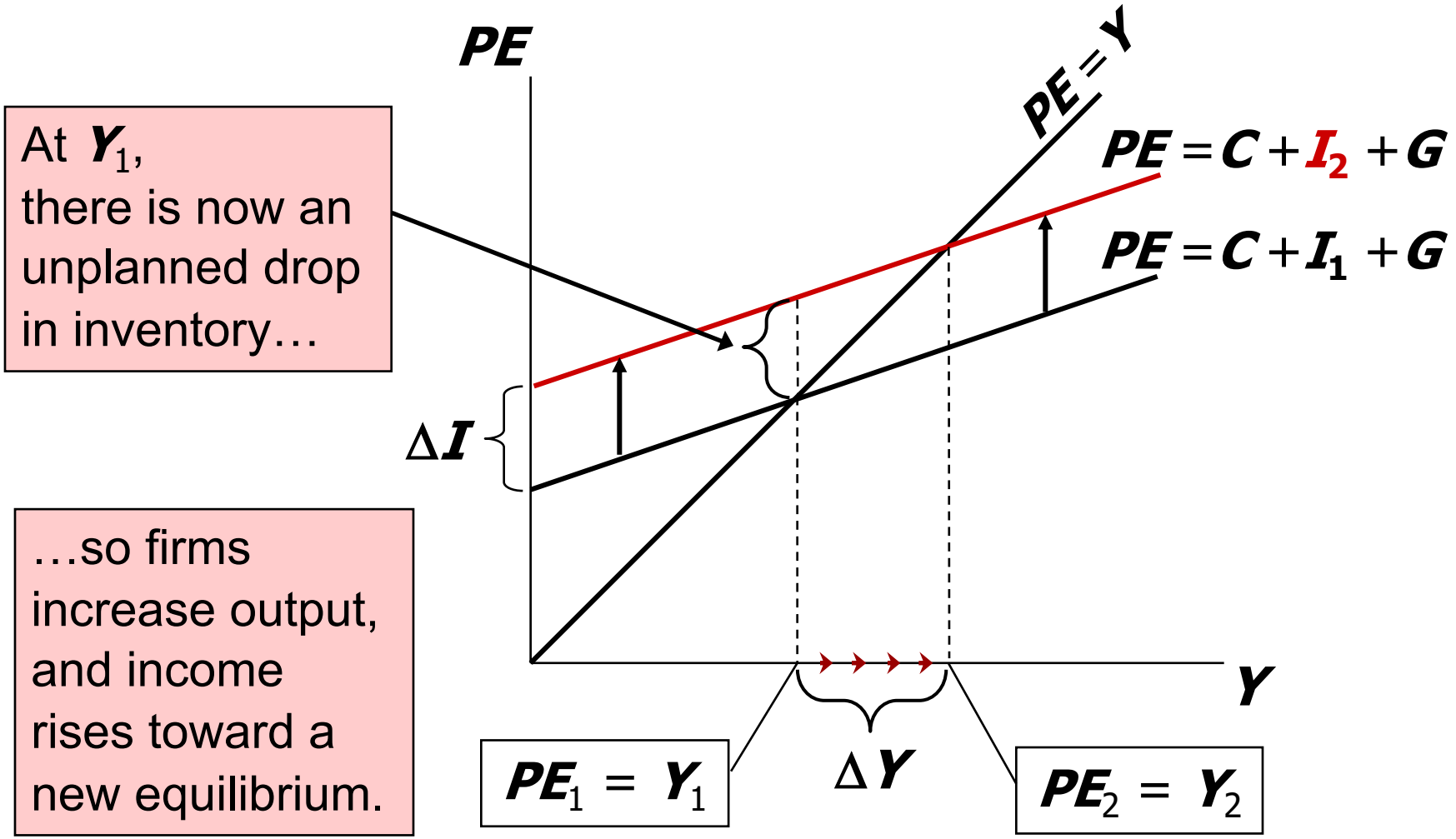
NOW YOU TRY

Practice with the Keynesian cross

- Use a graph of the Keynesian cross to show the effects of an increase in planned investment on the equilibrium level of income/output.

ANSWERS

Practice with the Keynesian cross



The *IS* curve

def: a graph of all combinations of r and Y that result in goods market equilibrium

i.e. actual expenditure (output)
= planned expenditure

The equation for the *IS* curve is:

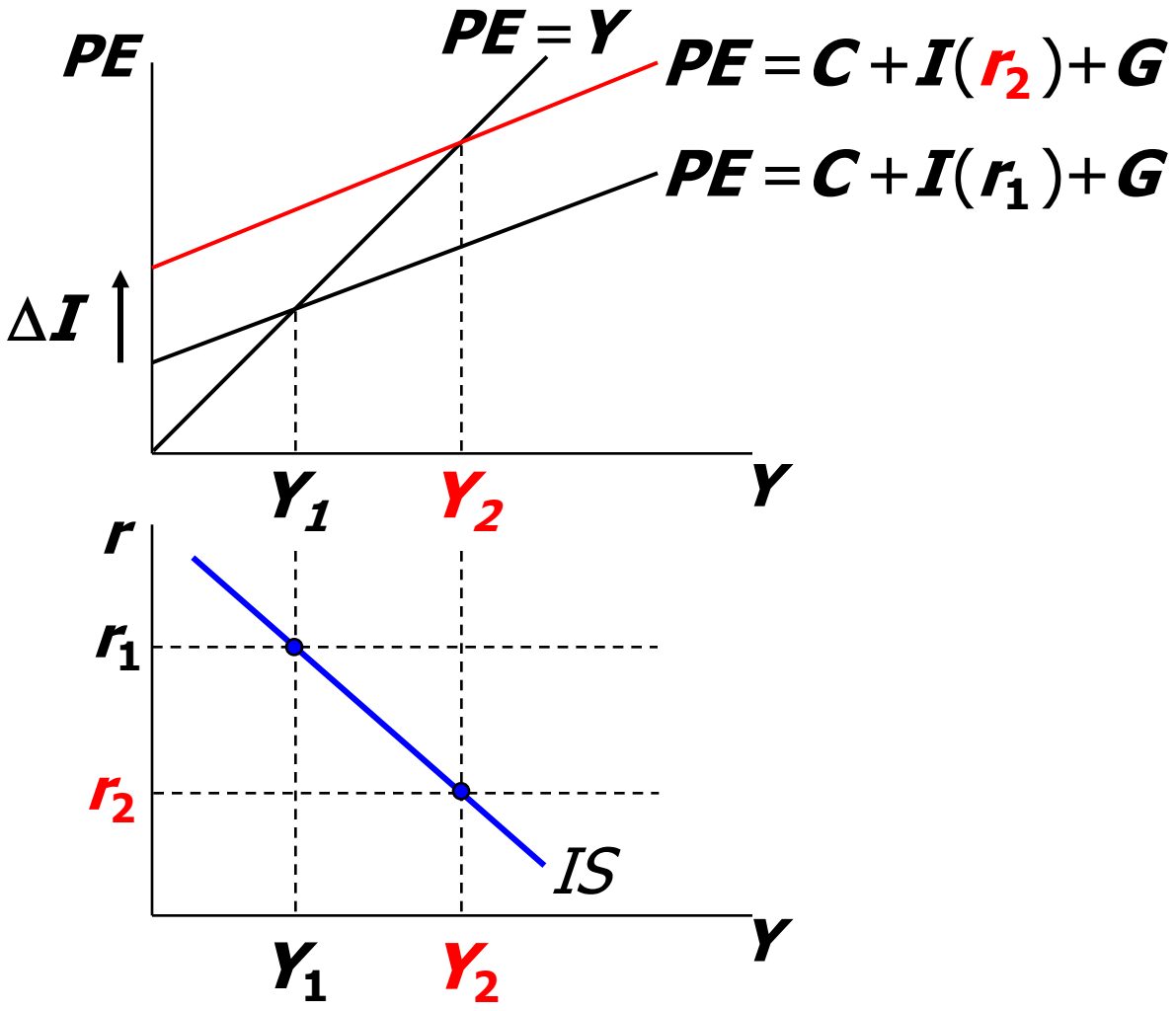
$$Y = C(Y - \overline{T}) + I(r) + \overline{G}$$

Deriving the *IS* curve

$\downarrow r \Rightarrow \uparrow I$

$\Rightarrow \uparrow PE$

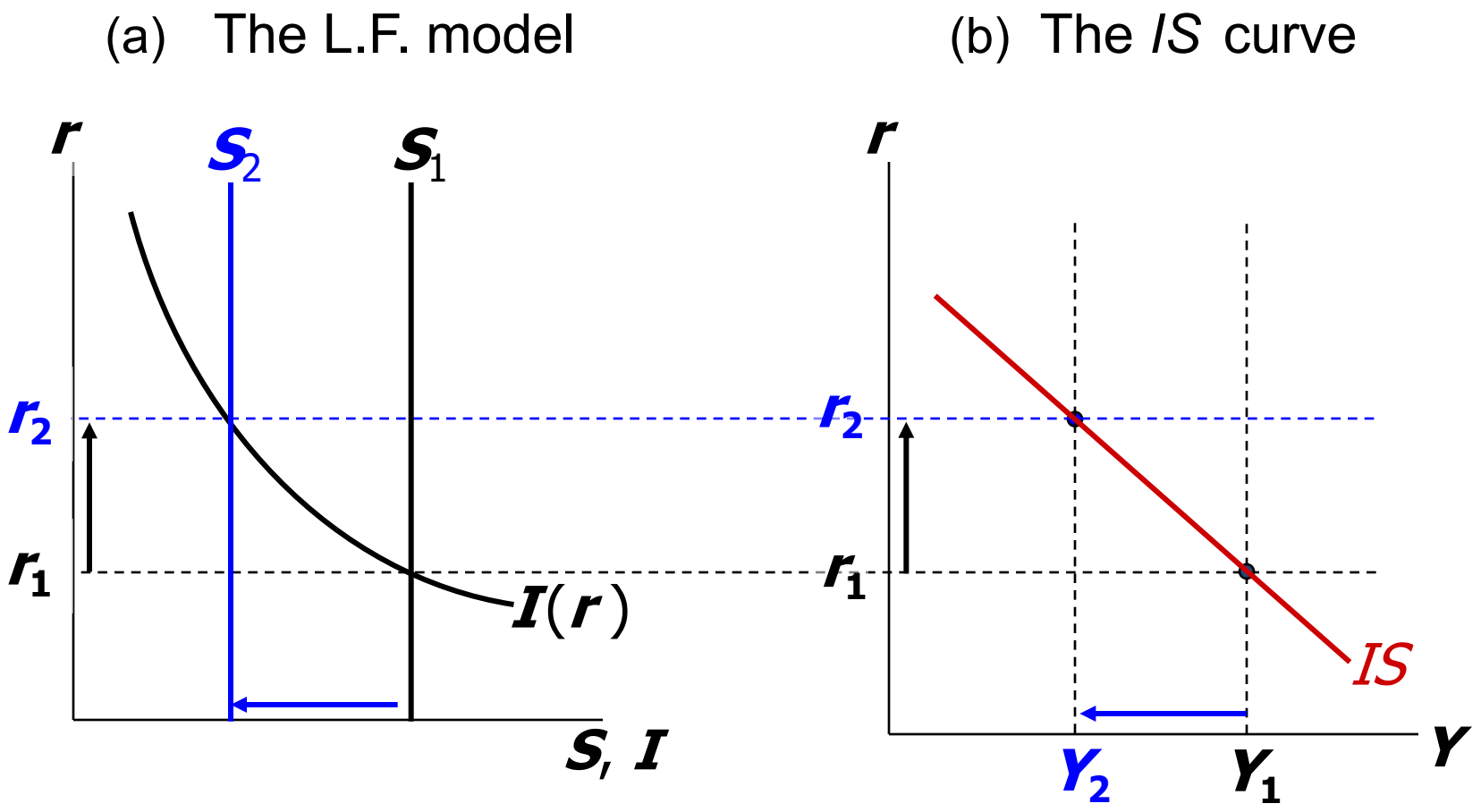
$\Rightarrow \uparrow Y$



Why the *IS* curve is negatively sloped

- A fall in the interest rate motivates firms to increase investment spending, which drives up total planned spending (***PE***).
- To restore equilibrium in the goods market, output (a.k.a. actual expenditure, ***Y***) must increase.

The *IS* curve and the loanable funds model



Fiscal Policy and the *IS* curve

- We can use the *IS*-*LM* model to see how fiscal policy (***G*** and ***T***) affects aggregate demand and output.
- Let's start by using the Keynesian cross to see how fiscal policy shifts the *IS* curve…

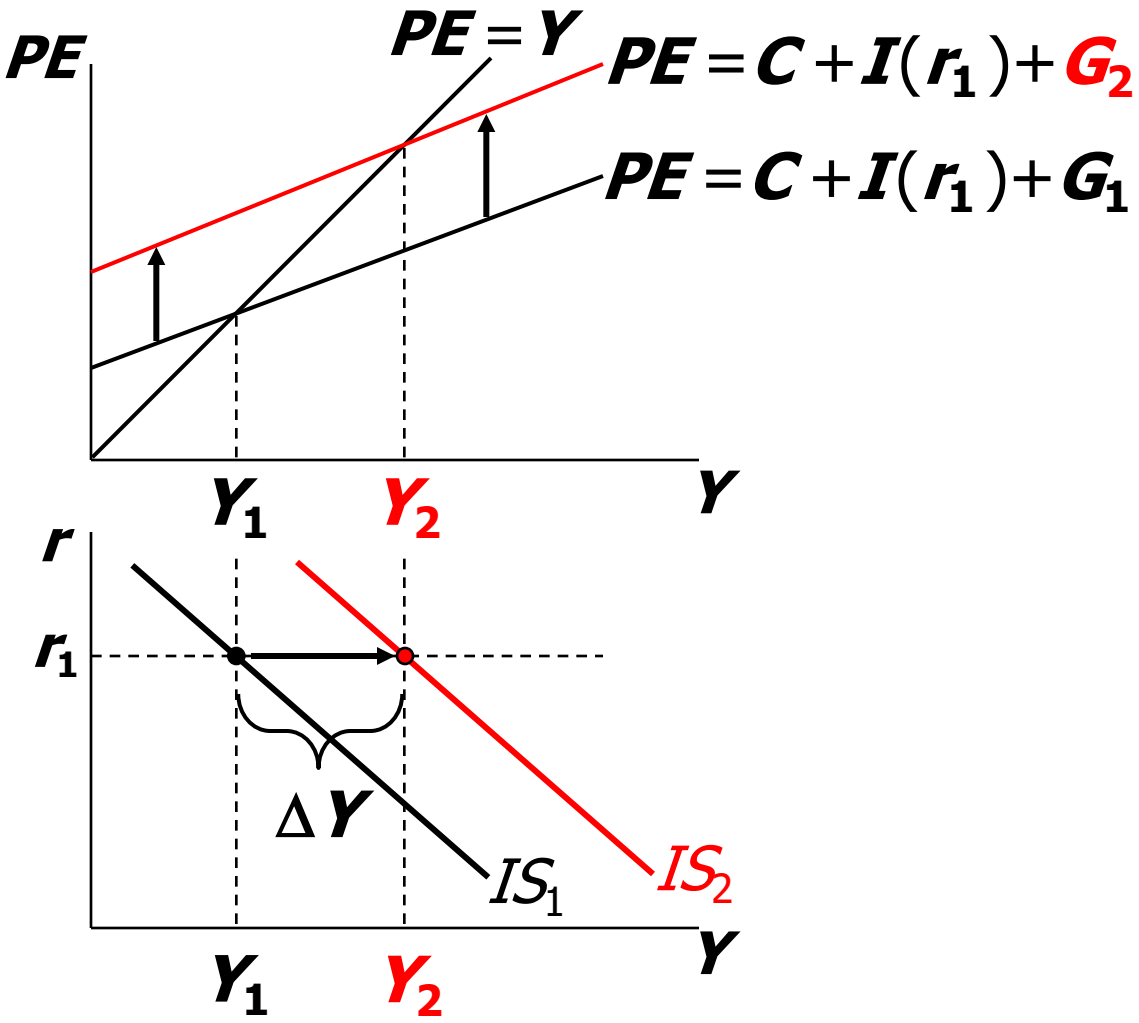
Shifting the *IS* curve: ΔG

At any value of r, $\uparrow G$
$\Rightarrow \uparrow PE \Rightarrow \uparrow Y$

…so the *IS* curve shifts to the right.

The horizontal distance of the *IS* shift equals

$$\Delta Y = \frac{1}{1-\text{MPC}} \Delta G$$



NOW YOU TRY

Shifting the IS curve: ΔT

- Use the diagram of the Keynesian cross or loanable funds model to show how an increase in taxes shifts the IS curve.
- If you can, determine the size of the shift.

ANSWERS

Shifting the IS curve: ΔT

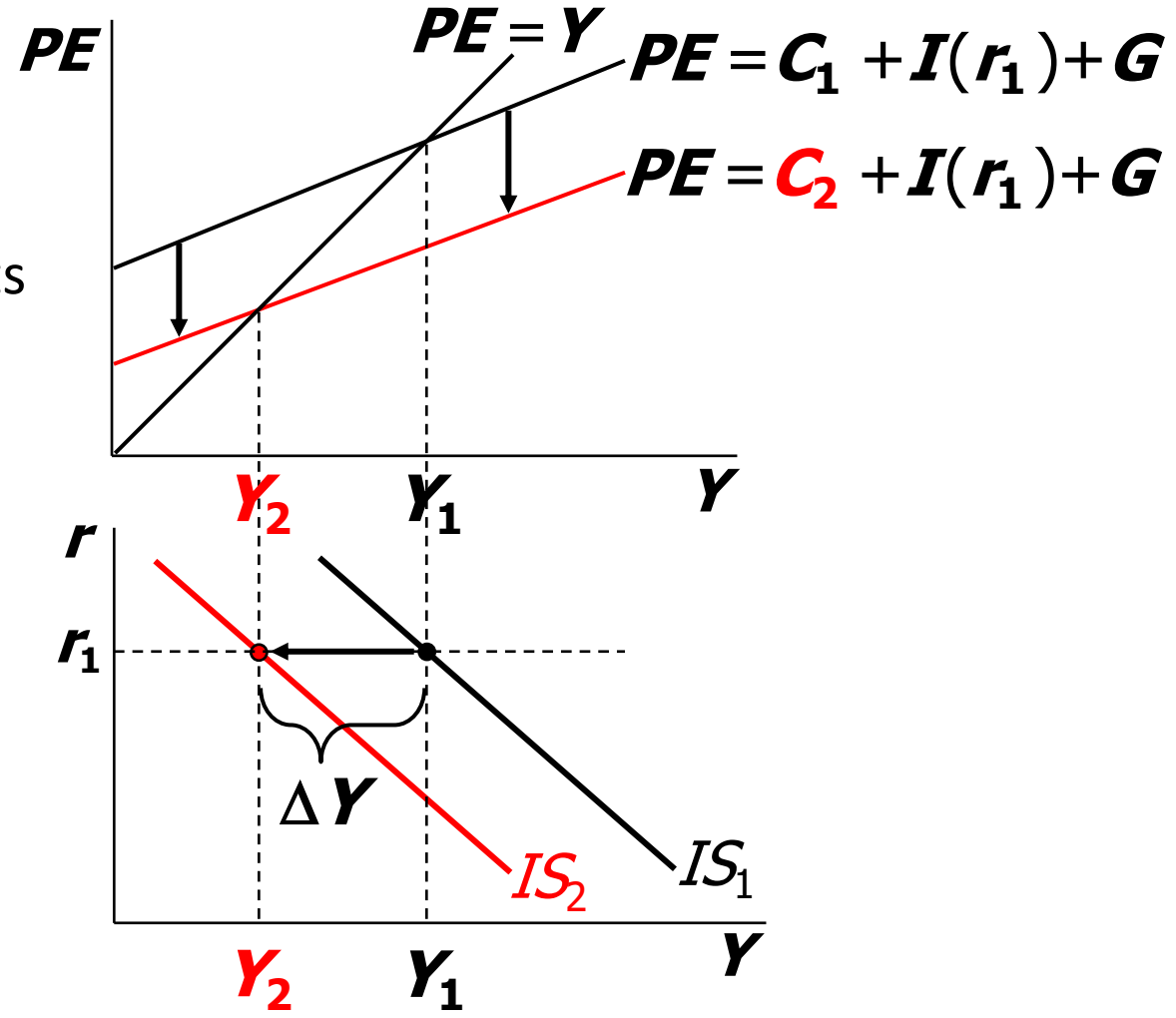
At any value of r,

$\uparrow T \Rightarrow \downarrow C \Rightarrow \downarrow PE$

…so the *IS* curve shifts to the left.

The horizontal distance of the *IS* shift equals

$$\Delta Y = \frac{-\text{MPC}}{1-\text{MPC}} \Delta T$$



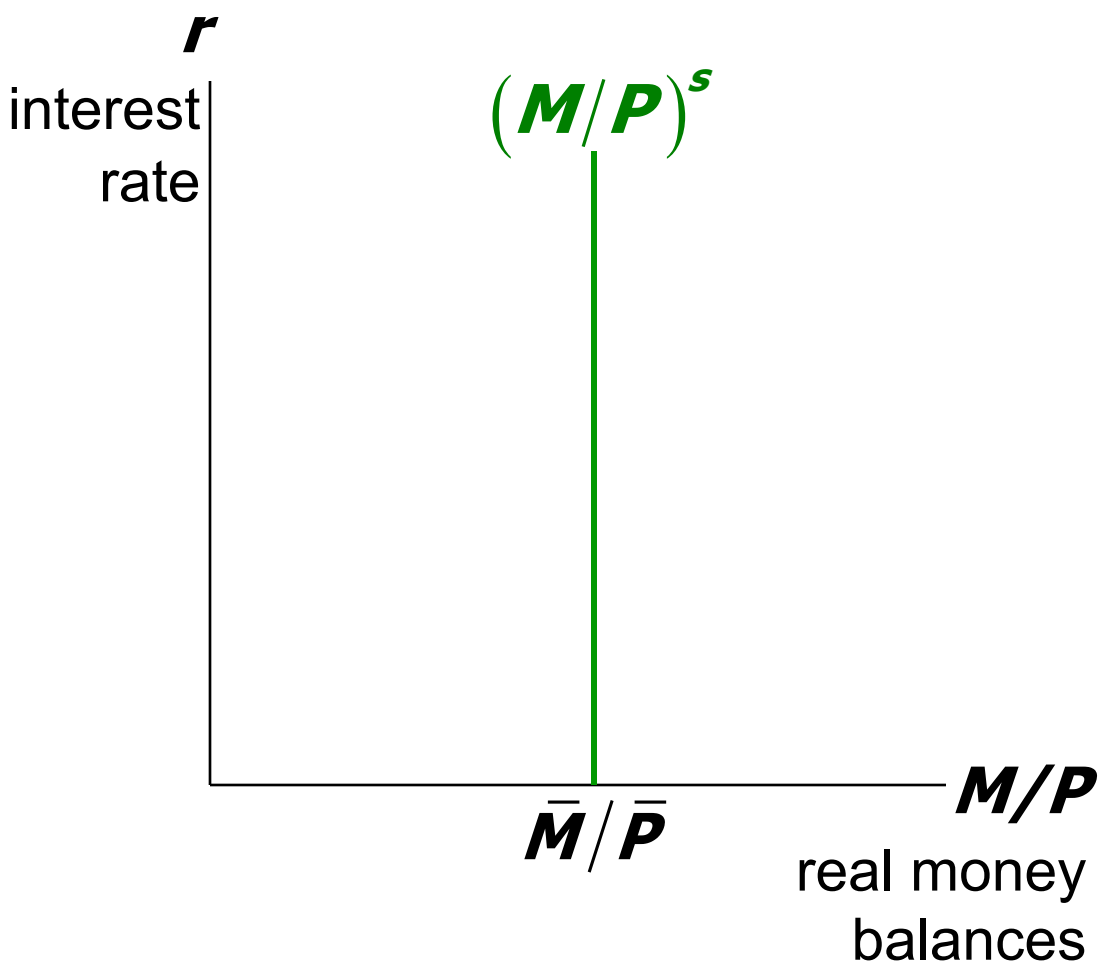
The theory of liquidity preference

- Due to John Maynard Keynes.
- A simple theory in which the interest rate is determined by money supply and money demand.

Money supply

The supply of real money balances is fixed:

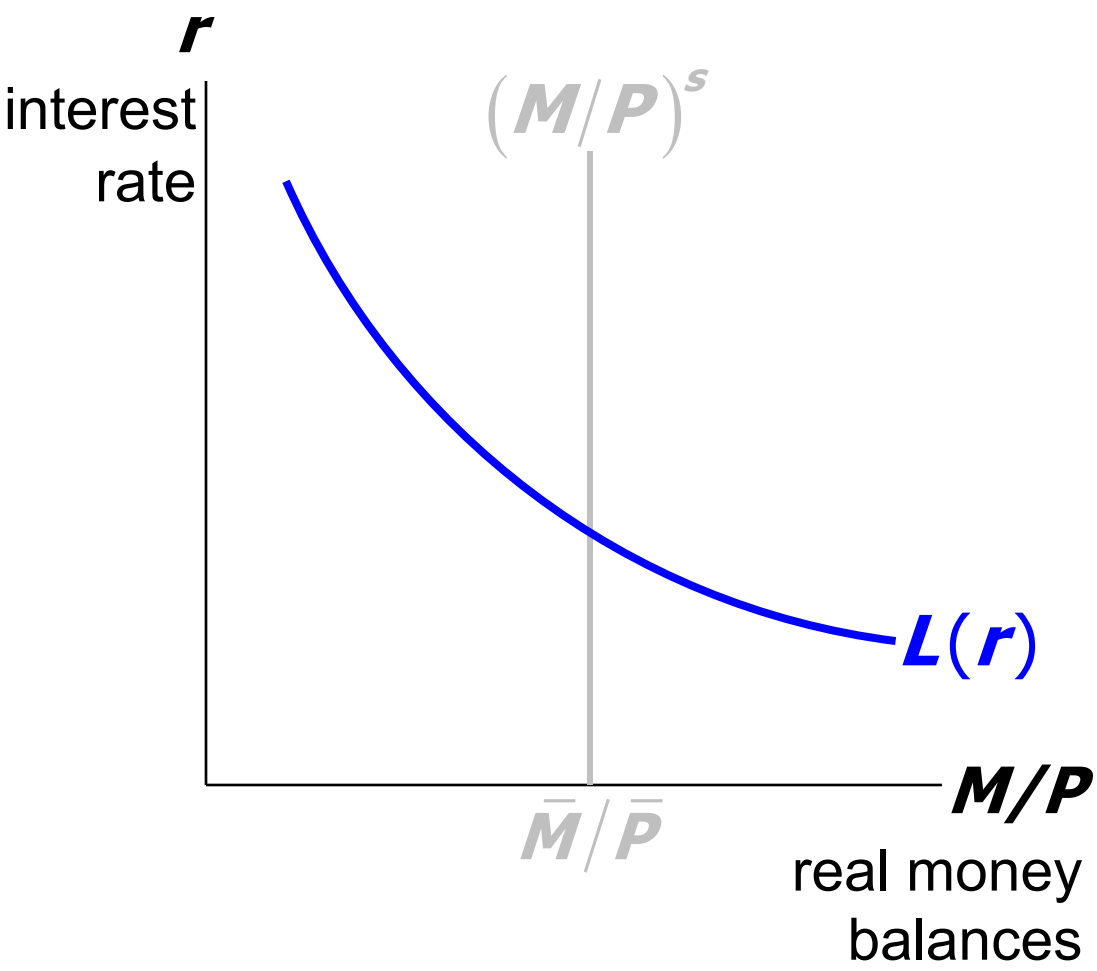
$$\left(M/P\right)^{s} = \bar{M}/\bar{P}$$



Money demand

Demand for real money balances:

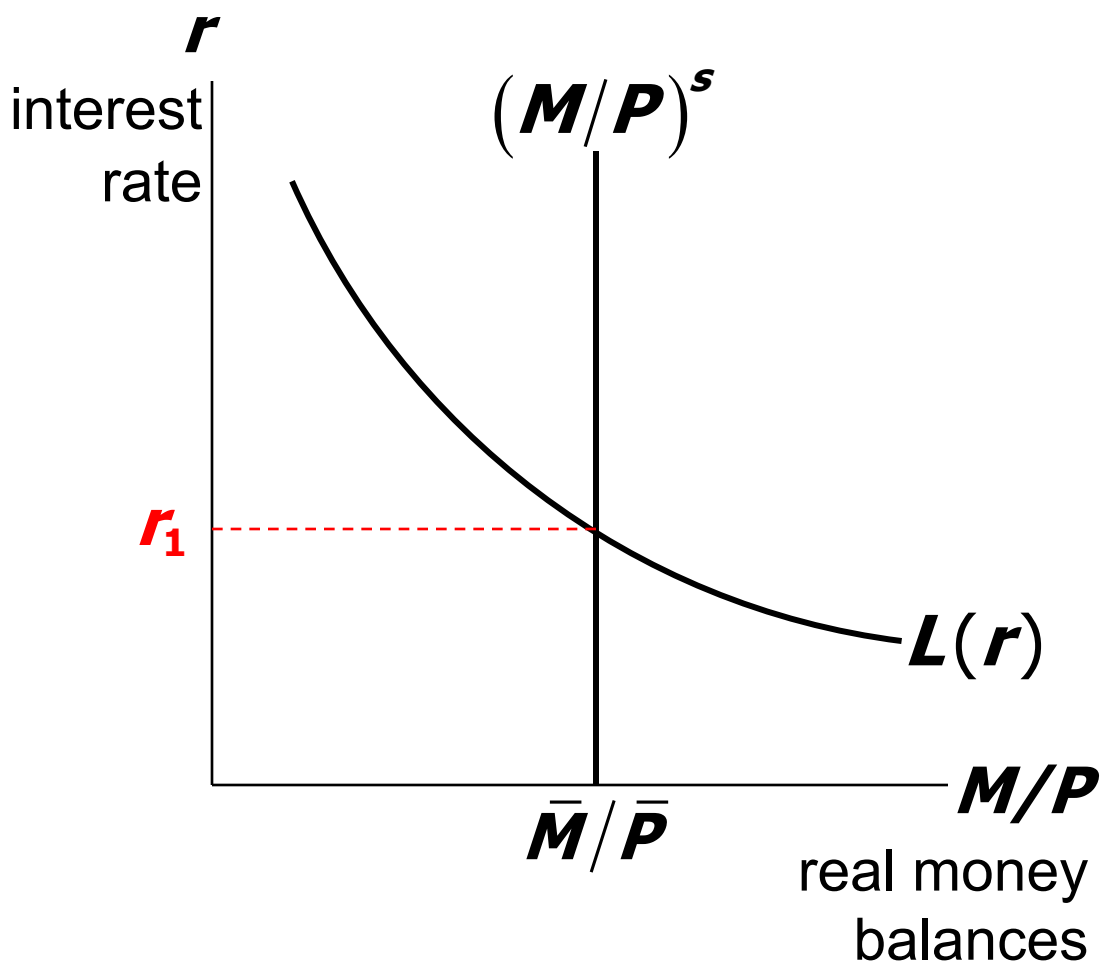
$$\left(M/P\right)^{d} = L(r)$$



Equilibrium

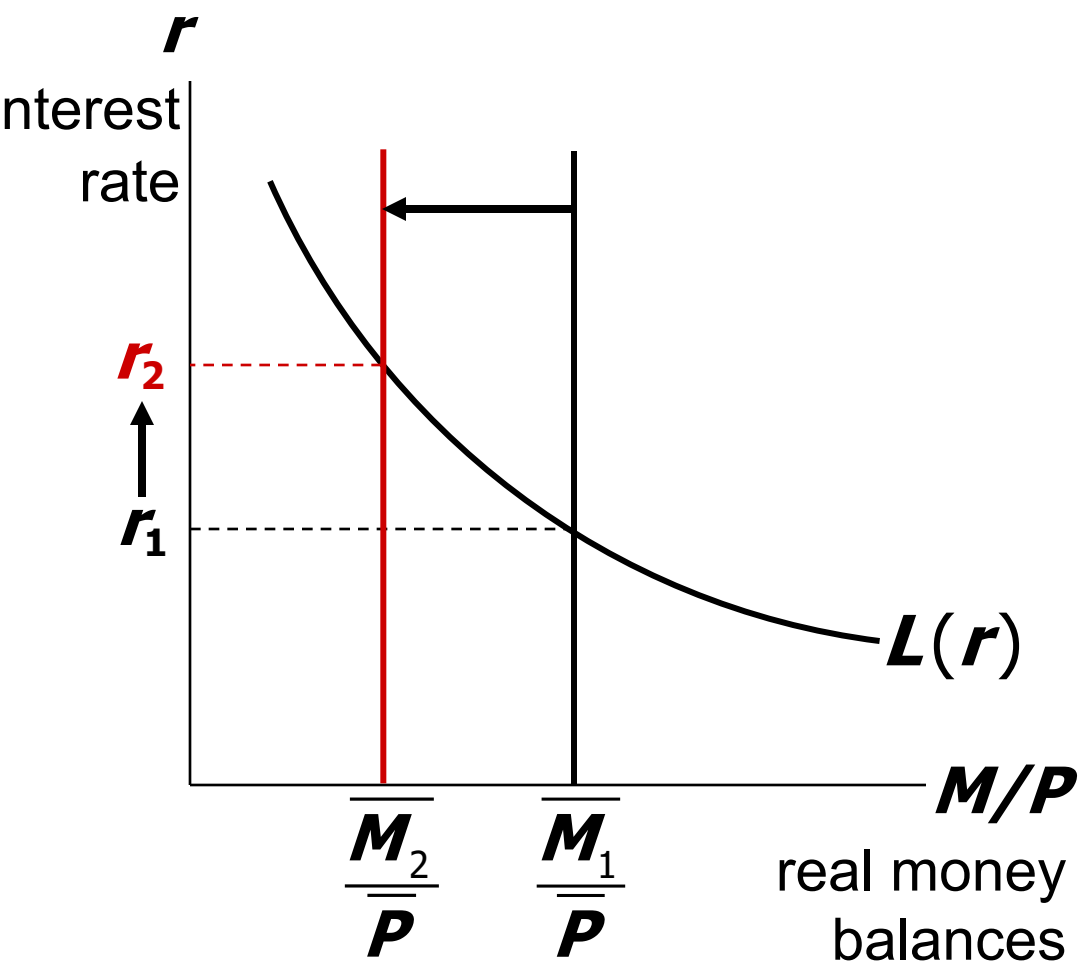
The interest rate adjusts to equate the supply and demand for money:

$$\overline{M}/\overline{P} = L(r)$$



How the Fed raises the interest rate

To increase ***r***, Fed reduces ***M***



CASE STUDY:

Monetary Tightening & Interest Rates

- Late 1970s: $\pi > 10\%$
- Oct 1979: Fed Chairman Paul Volcker announces that monetary policy would aim to reduce inflation
- Aug 1979–April 1980: Fed reduces ***M/P*** 8.0%
- Jan 1983: $\pi = 3.7\%$

How do you think this policy change would affect nominal interest rates?

The *LM* curve

Now let's put Y back into the money demand function:

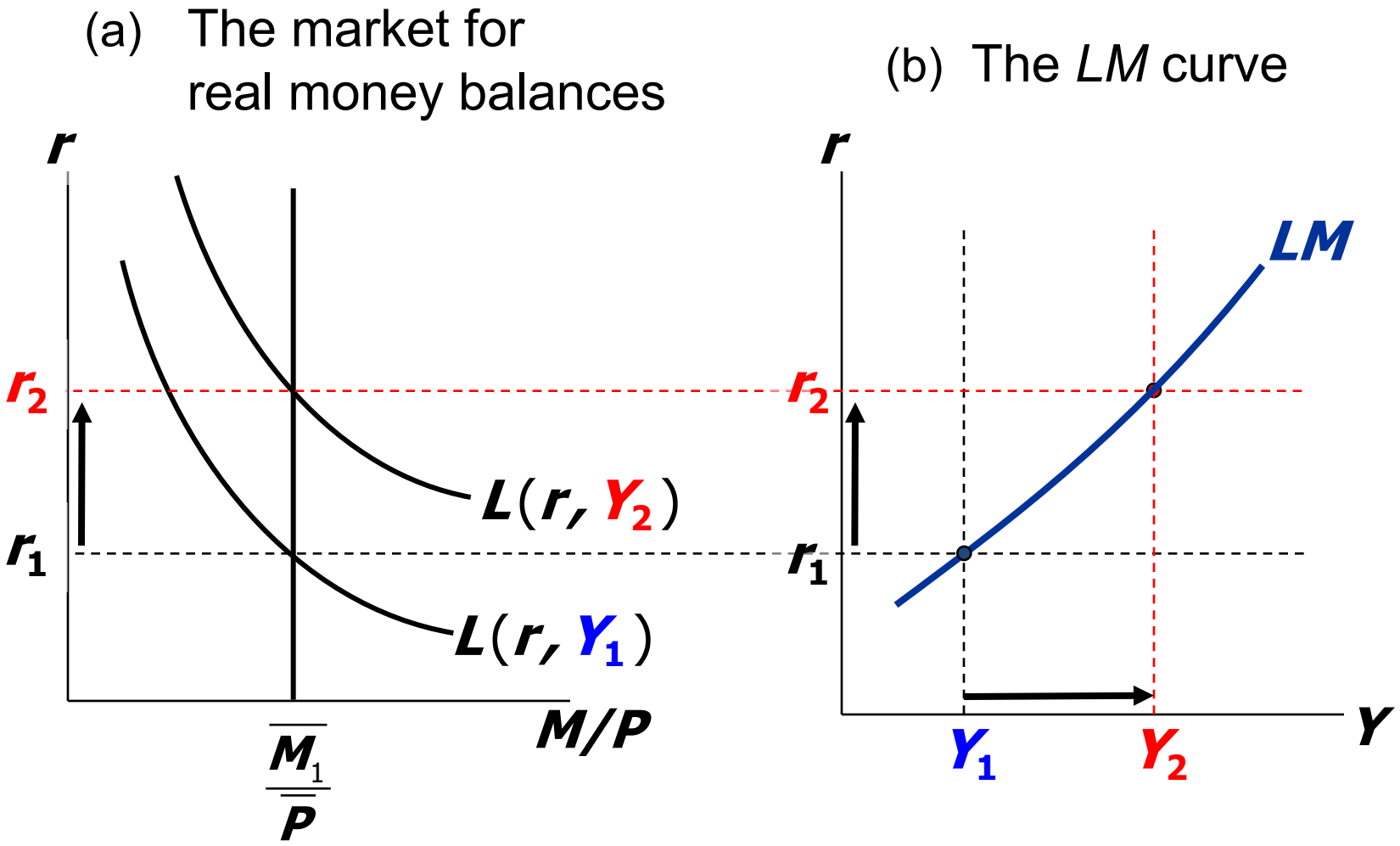
$$(M/P)^d = L(r,Y)$$

The ***LM* curve** is a graph of all combinations of r and Y that equate the supply and demand for real money balances.

The equation for the *LM* curve is:

$$\bar{M}/\bar{P} = L(r,Y)$$

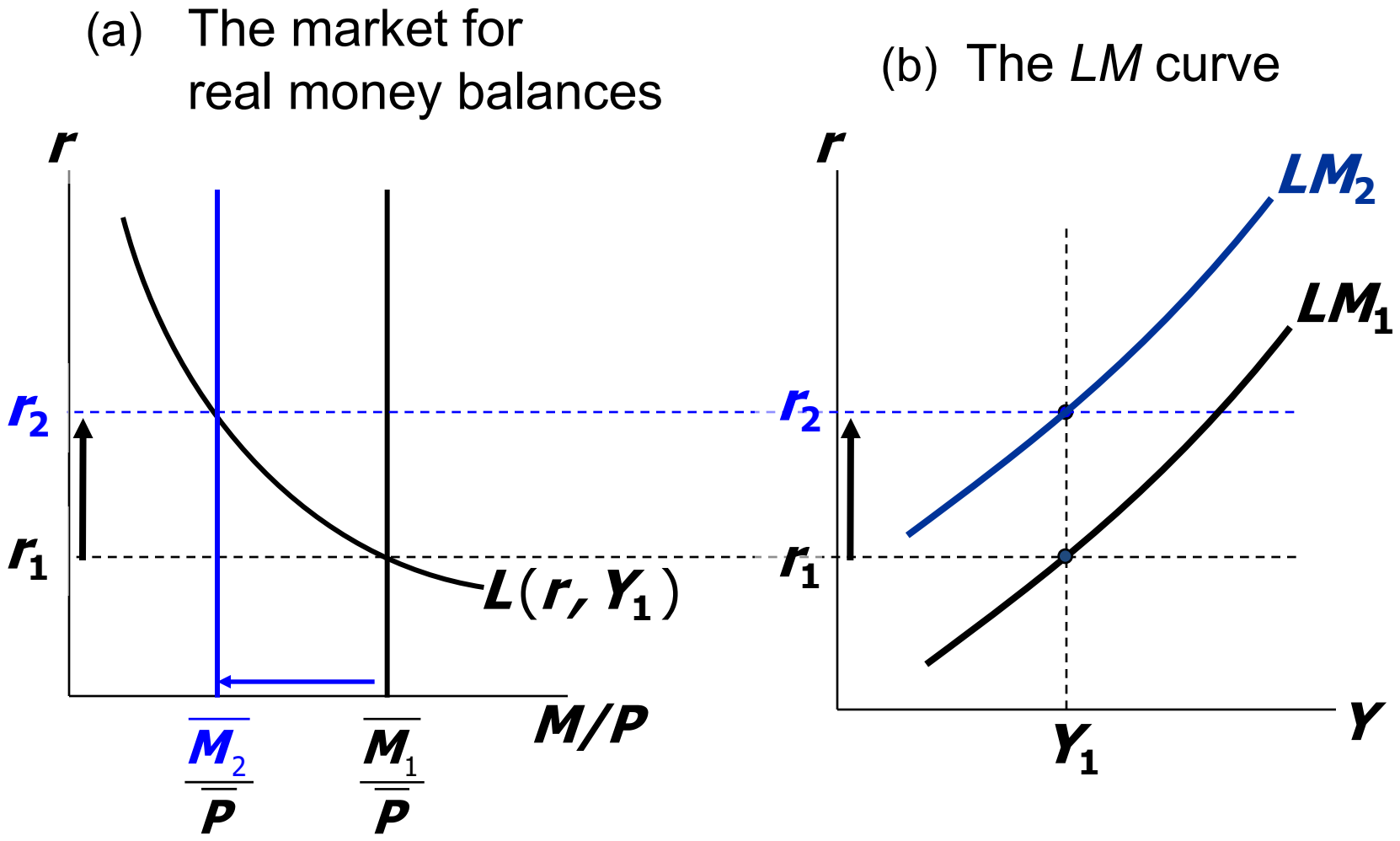
Deriving the *LM* curve



Why the *LM* curve is upward sloping

- An increase in income raises money demand.
- Since the supply of real balances is fixed, there is now excess demand in the money market at the initial interest rate.
- The interest rate must rise to restore equilibrium in the money market.

How ΔM shifts the *LM* curve



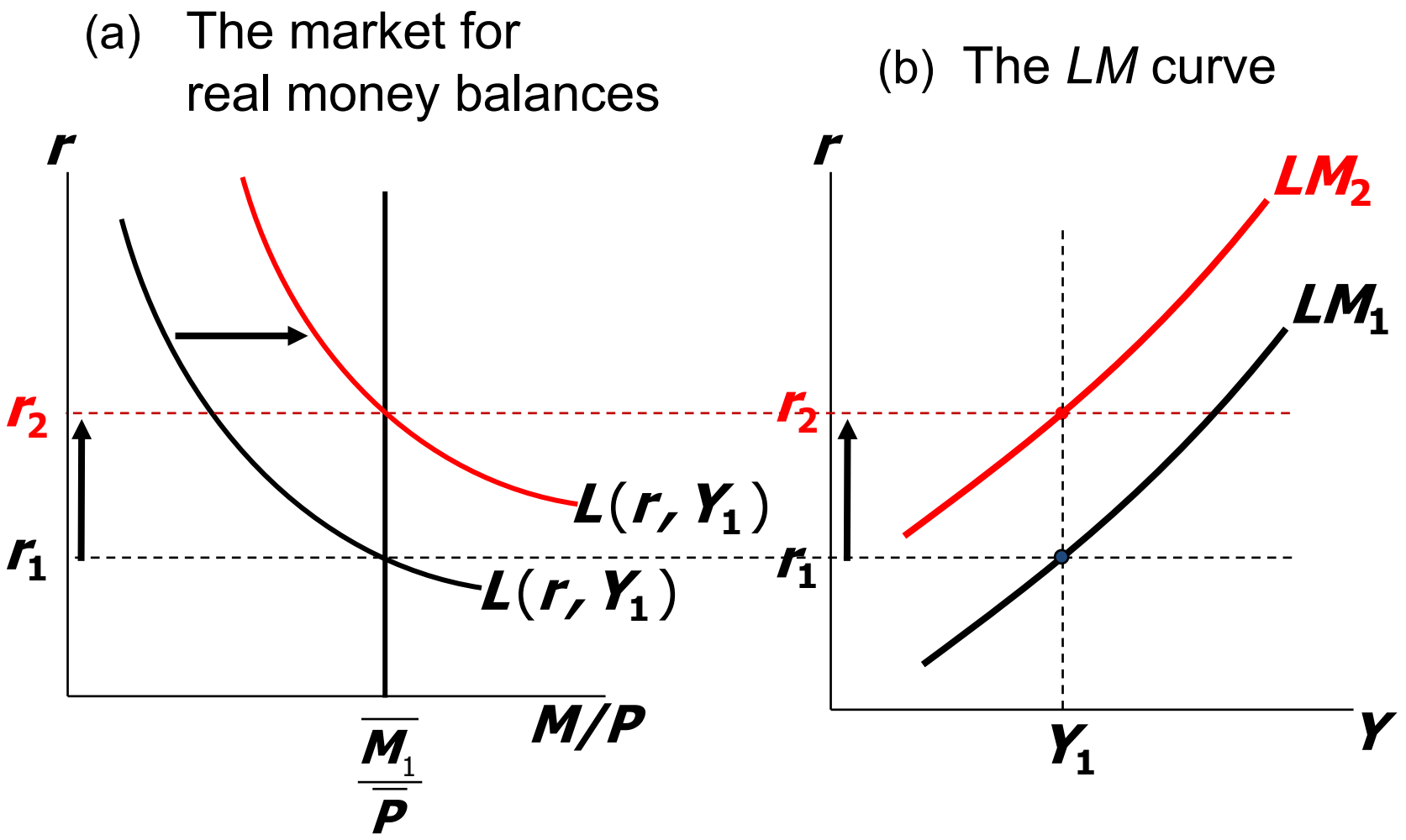
NOW YOU TRY

Shifting the *LM* curve

- Suppose a wave of credit card fraud causes consumers to use cash more frequently in transactions.
- Use the liquidity preference model to show how these events shift the *LM* curve.

ANSWERS

Shifting the *LM* curve

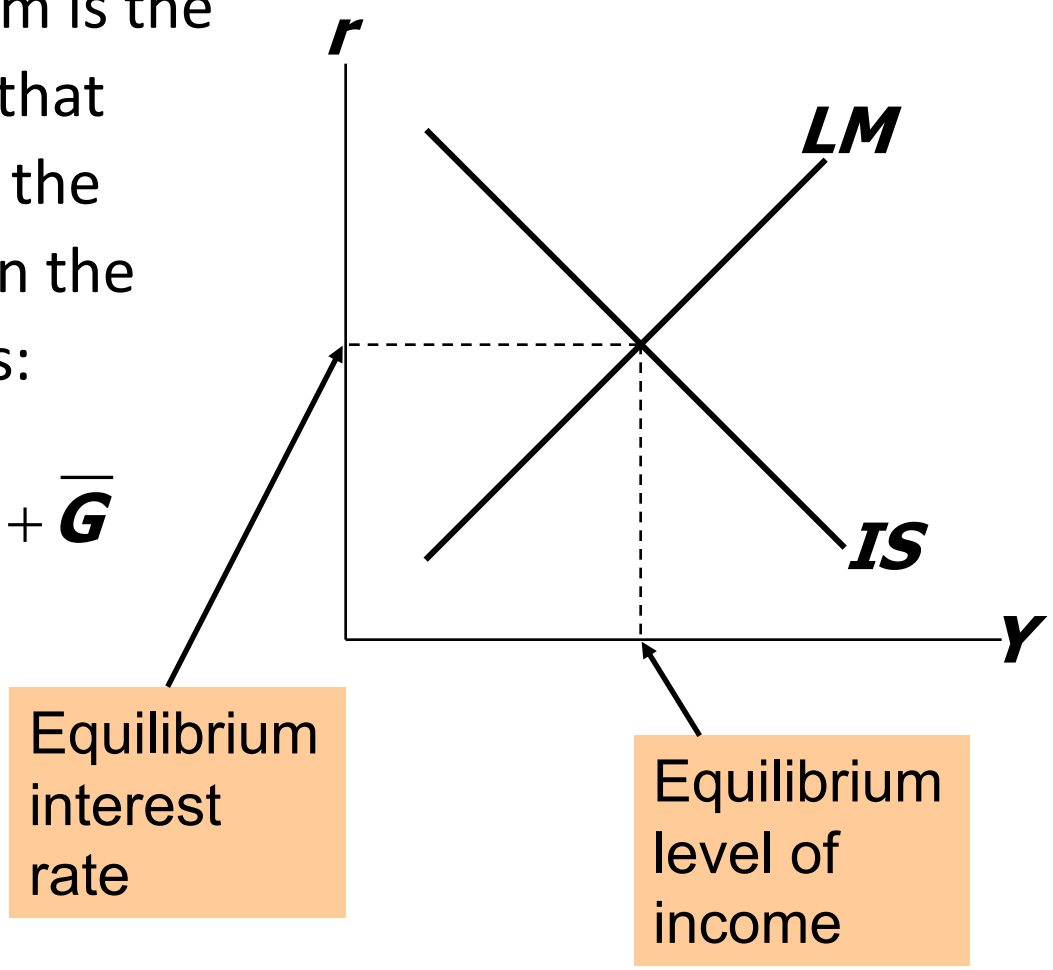


The short-run equilibrium

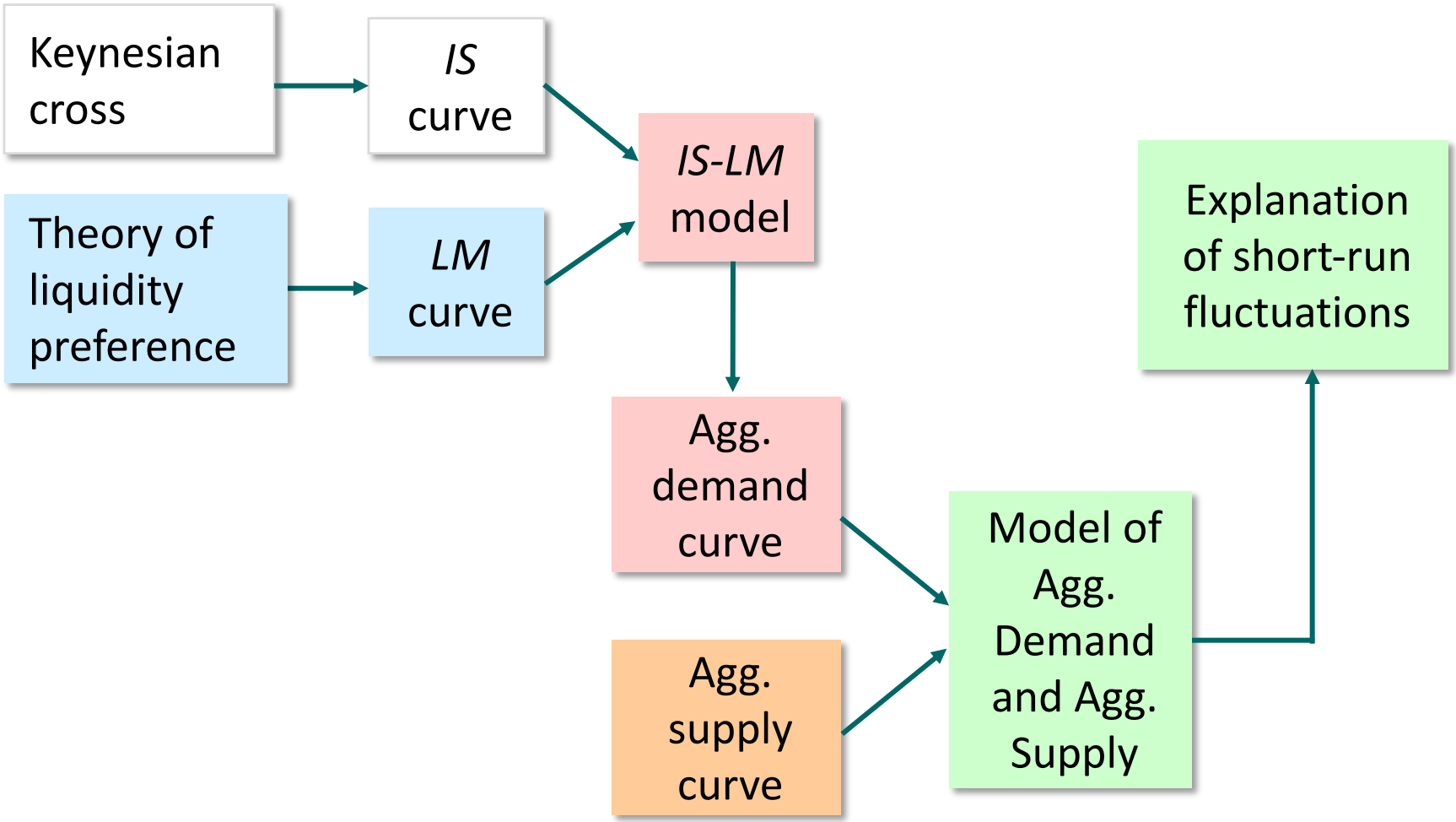
The short-run equilibrium is the combination of r and Y that simultaneously satisfies the equilibrium conditions in the goods & money markets:

$$Y = C(Y - \bar{T}) + I(r) + \bar{G}$$

$$\bar{M}/\bar{P} = L(r, Y)$$



The Big Picture



Preview of Chapter 12

In Chapter 12, we will

- use the *IS-LM* model to analyze the impact of policies and shocks.
- learn how the aggregate demand curve comes from *IS-LM*.
- use the *IS-LM* and *AD-AS* models together to analyze the short-run and long-run effects of shocks.
- use our models to learn about the Great Depression.

CHAPTER SUMMARY

1. Keynesian cross
   - basic model of income determination
   - takes fiscal policy & investment as exogenous
   - fiscal policy has a multiplier effect on income
2. *IS* curve
   - comes from Keynesian cross when planned investment depends negatively on interest rate
   - shows all combinations of ***r*** and ***Y*** that equate planned expenditure with actual expenditure on goods & services

CHAPTER SUMMARY

3. Theory of liquidity preference
   - basic model of interest rate determination
   - takes money supply & price level as exogenous
   - an increase in the money supply lowers the interest rate
4. *LM* curve
   - comes from liquidity preference theory when money demand depends positively on income
   - shows all combinations of ***r*** and ***Y*** that equate demand for real money balances with supply

CHAPTER SUMMARY

5. *IS-LM* model
   - Intersection of *IS* and *LM* curves shows the unique point (***Y***, ***r***) that satisfies equilibrium in both the goods and money markets.