Chapter 12

Aggregate Demand II: Applying the *IS*-*LM* Model

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Aggregate Demand II: Applying the *IS-LM* Model

MACROECONOMICS

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PowerPoint® Slides by Ron Cronovich

Context

- Chapter 10 introduced the model of aggregate demand and supply.
- Chapter 11 developed the *IS-LM* model, the basis of the aggregate demand curve.

IN THIS CHAPTER, YOU WILL LEARN:

- how to use the *IS-LM* model to analyze the effects of shocks, fiscal policy, and monetary policy
- how to derive the aggregate demand curve from the *IS-LM* model
- several theories about what caused the Great Depression

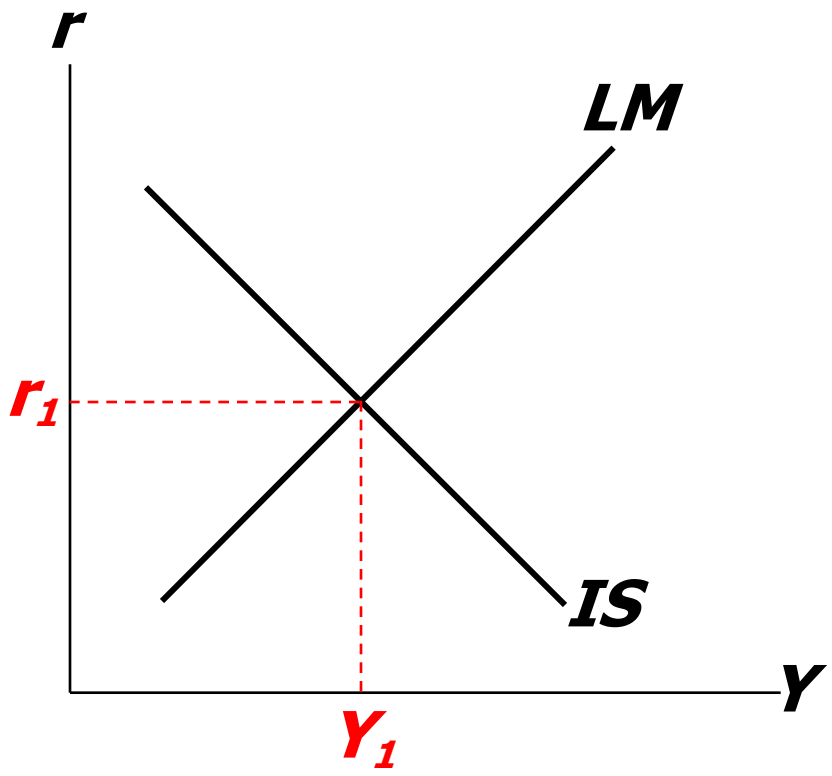
Equilibrium in the *IS*-*LM* model

The *IS* curve represents equilibrium in the goods market.

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

The *LM* curve represents money market equilibrium.

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



The intersection determines the unique combination of ***Y*** and ***r*** that satisfies equilibrium in both markets.

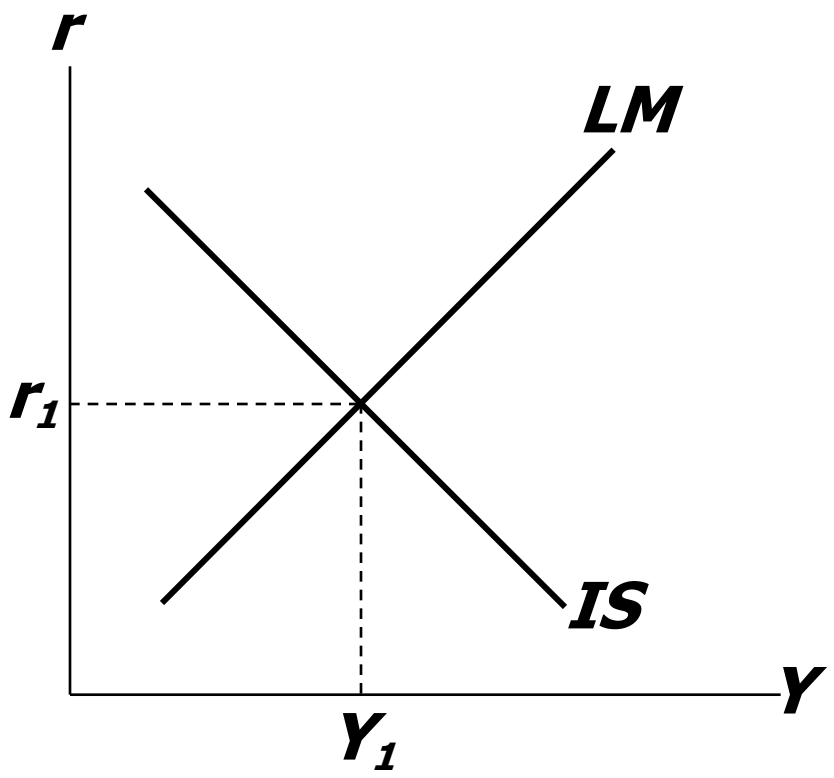
Policy analysis with the *IS-LM* model

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

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

We can use the *IS-LM* model to analyze the effects of

- fiscal policy: G and/or T
- monetary policy: M



An increase in government purchases

1. *IS* curve shifts right

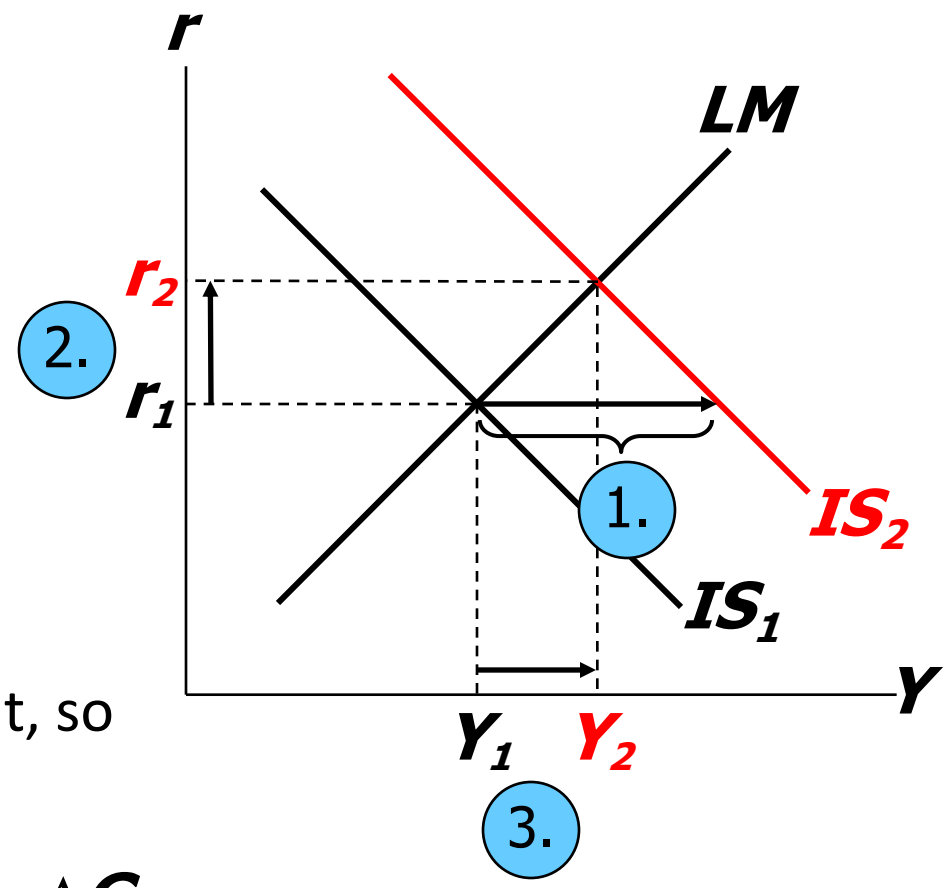
   by $\frac{1}{1 - MPC} \Delta G$

   causing output & income to rise.

2. This raises money demand, causing the interest rate to rise…

3. …which reduces investment, so the final increase in Y

   is smaller than $\frac{1}{1 - MPC} \Delta G$



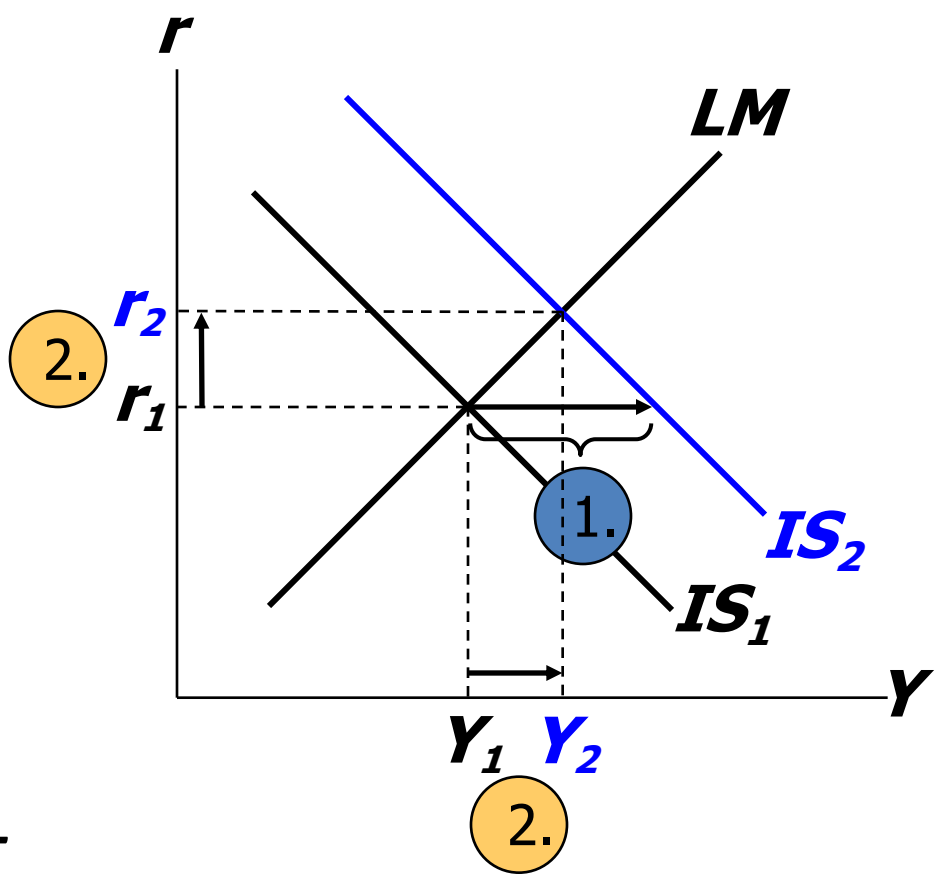
A tax cut

Consumers save (1–*MPC*) of the tax cut, so the initial boost in spending is smaller for ΔT than for an equal ΔG…

and the *IS* curve shifts by

1. $\dfrac{-MPC}{1 - MPC} \Delta T$

2. …so the effects on r and Y are smaller for ΔT than for an equal ΔG.

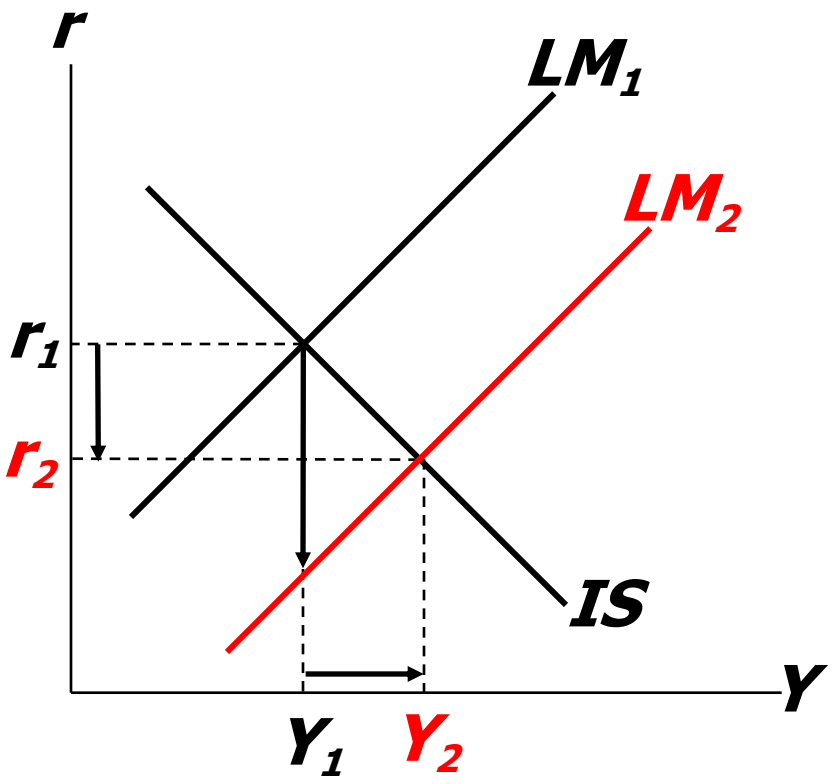


Monetary policy: An increase in *M*

1. $\Delta M > 0$ shifts the *LM* curve down (or to the right)

2. …causing the interest rate to fall

3. …which increases investment, causing output & income to rise.



Interaction between monetary & fiscal policy

- Model:
  - Monetary & fiscal policy variables (***M***, ***G,*** and ***T***) are exogenous.
- Real world:
  - Monetary policymakers may adjust ***M*** in response to changes in fiscal policy, or vice versa.
  - Such interactions may alter the impact of the original policy change.

The Fed's response to $\Delta G > 0$

- Suppose Congress increases ***G***.
- Possible Fed responses:
  1. hold ***M*** constant
  2. hold ***r*** constant
  3. hold ***Y*** constant
- In each case, the effects of the ΔG are different…

Response 1: Hold *M* constant

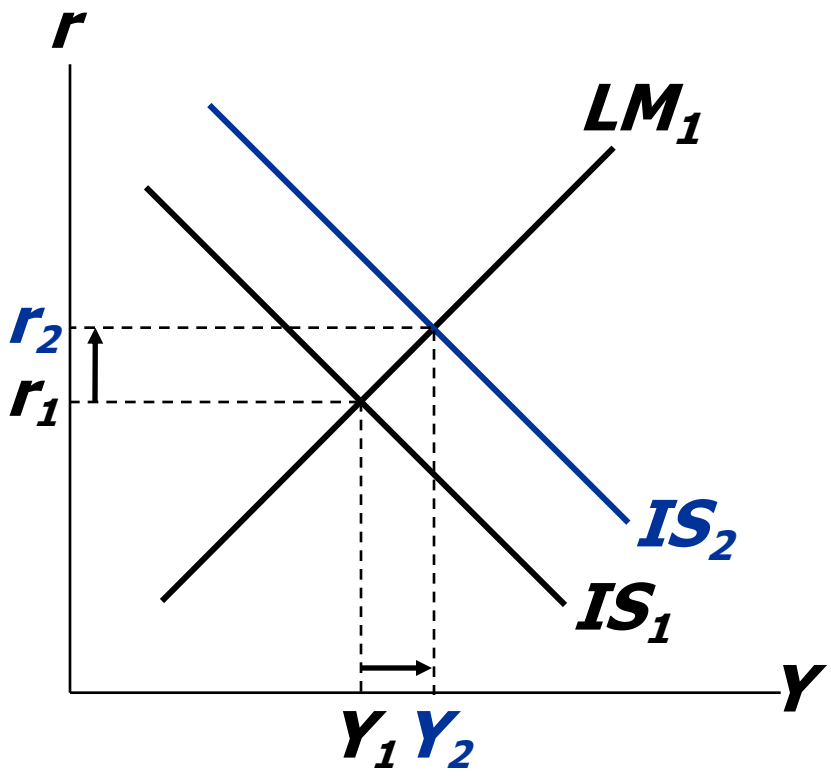
If Congress raises ***G***,
the *IS* curve shifts right.

If Fed holds ***M*** constant,
then *LM* curve doesn't
shift.

Results:

$$\Delta \boldsymbol{Y} = \boldsymbol{Y}_2 - \boldsymbol{Y}_1$$

$$\Delta \boldsymbol{r} = \boldsymbol{r}_2 - \boldsymbol{r}_1$$



Response 2: Hold *r* constant

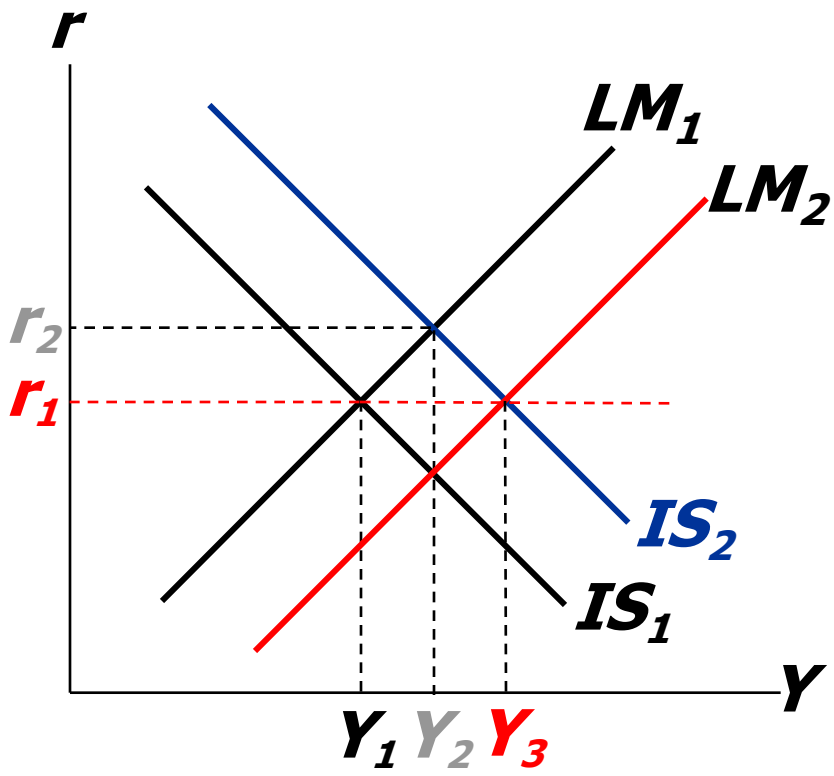
If Congress raises ***G***,
the *IS* curve shifts right.

To keep ***r*** constant, Fed
increases ***M***
to shift *LM* curve right.

Results:

$$\Delta \boldsymbol{Y} = \boldsymbol{Y}_3 - \boldsymbol{Y}_1$$

$$\Delta \boldsymbol{r} = 0$$



Response 3: Hold *Y* constant

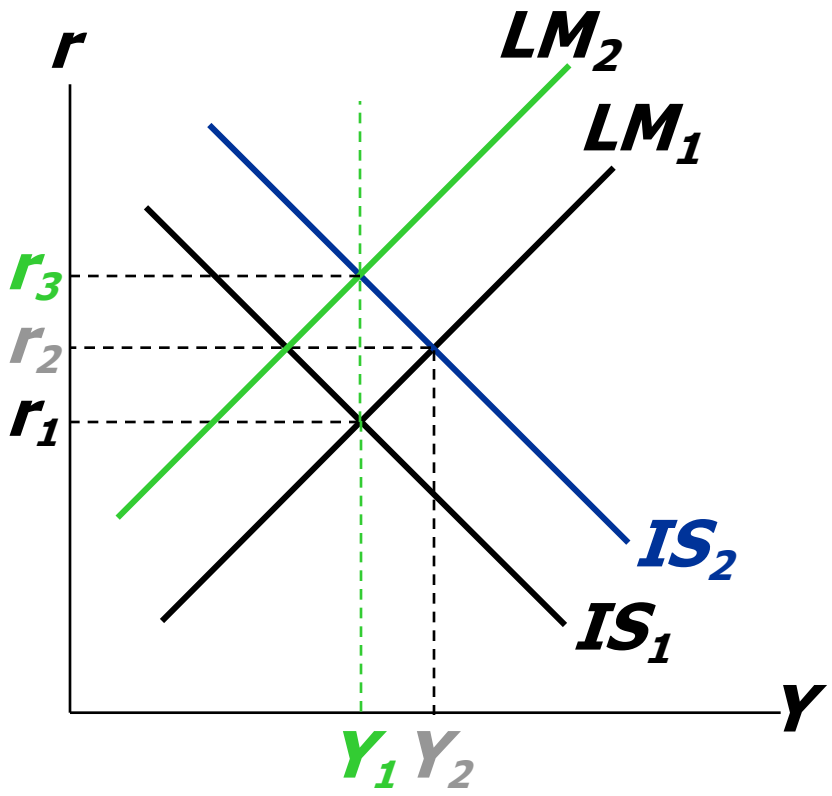
If Congress raises ***G***,
the *IS* curve shifts right.

To keep ***Y*** constant, Fed
reduces ***M***
to shift *LM* curve left.

Results:

$$\Delta \boldsymbol{Y} = 0$$

$$\Delta \boldsymbol{r} = \boldsymbol{r}_3 - \boldsymbol{r}_1$$



Shocks in the *IS-LM* model

***IS* shocks**: exogenous changes in the demand for goods & services.

Examples:

- stock market boom or crash
  $\Rightarrow$ change in households' wealth
  $\Rightarrow \Delta \boldsymbol{C}$
- change in business or consumer confidence or expectations
  $\Rightarrow \Delta \boldsymbol{I}$ and/or $\Delta \boldsymbol{C}$

Shocks in the *IS-LM* model

***LM* shocks**: exogenous changes in the demand for money.

Examples:

- A wave of credit card fraud increases demand for money.
- More ATMs or the Internet reduce money demand.

NOW YOU TRY

Analyze shocks with the *IS-LM* model

Use the *IS-LM* model to analyze the effects of

1. a housing market crash that reduces consumers' wealth
2. consumers using cash in transactions more frequently in response to an increase in identity theft

For each shock,

a. use the *IS-LM* diagram to determine the effects on ***Y*** and ***r*****.**
b. figure out what happens to ***C***, ***I***, and the unemployment rate.

Housing market crash

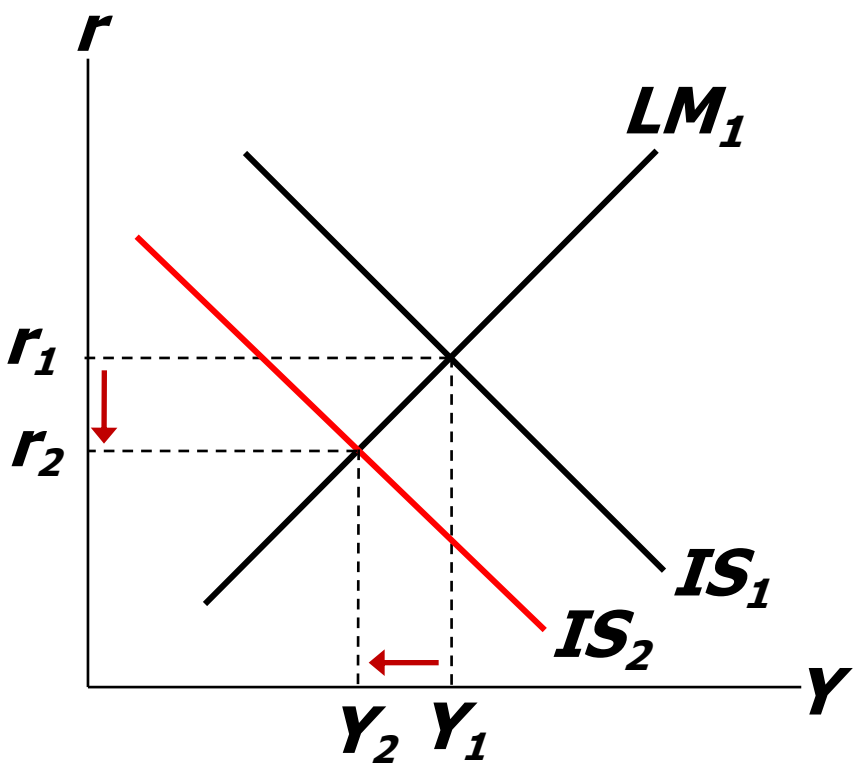
IS shifts left, causing

r and ***Y*** to fall.

C falls due to lower wealth and lower income,

I rises because ***r*** is lower

u rises because ***Y*** is lower (Okun's law)



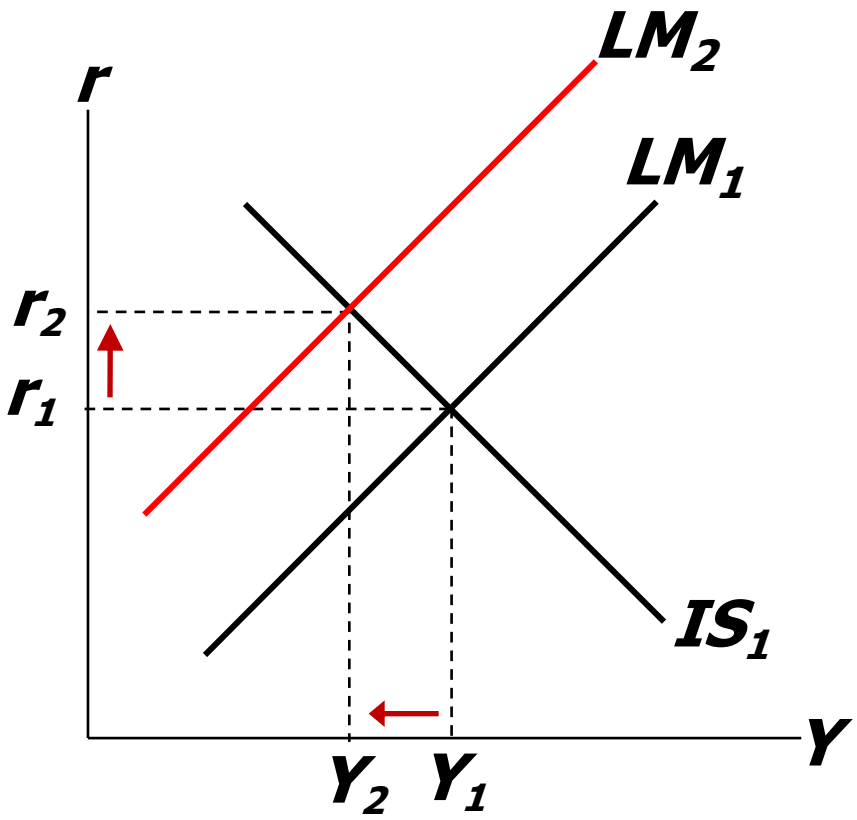
Increase in money demand

LM shifts left, causing ***r*** to rise and ***Y*** to fall.

C falls due to lower income,

I falls because ***r*** is higher

u rises because ***Y*** is lower (Okun's law)



CASE STUDY:

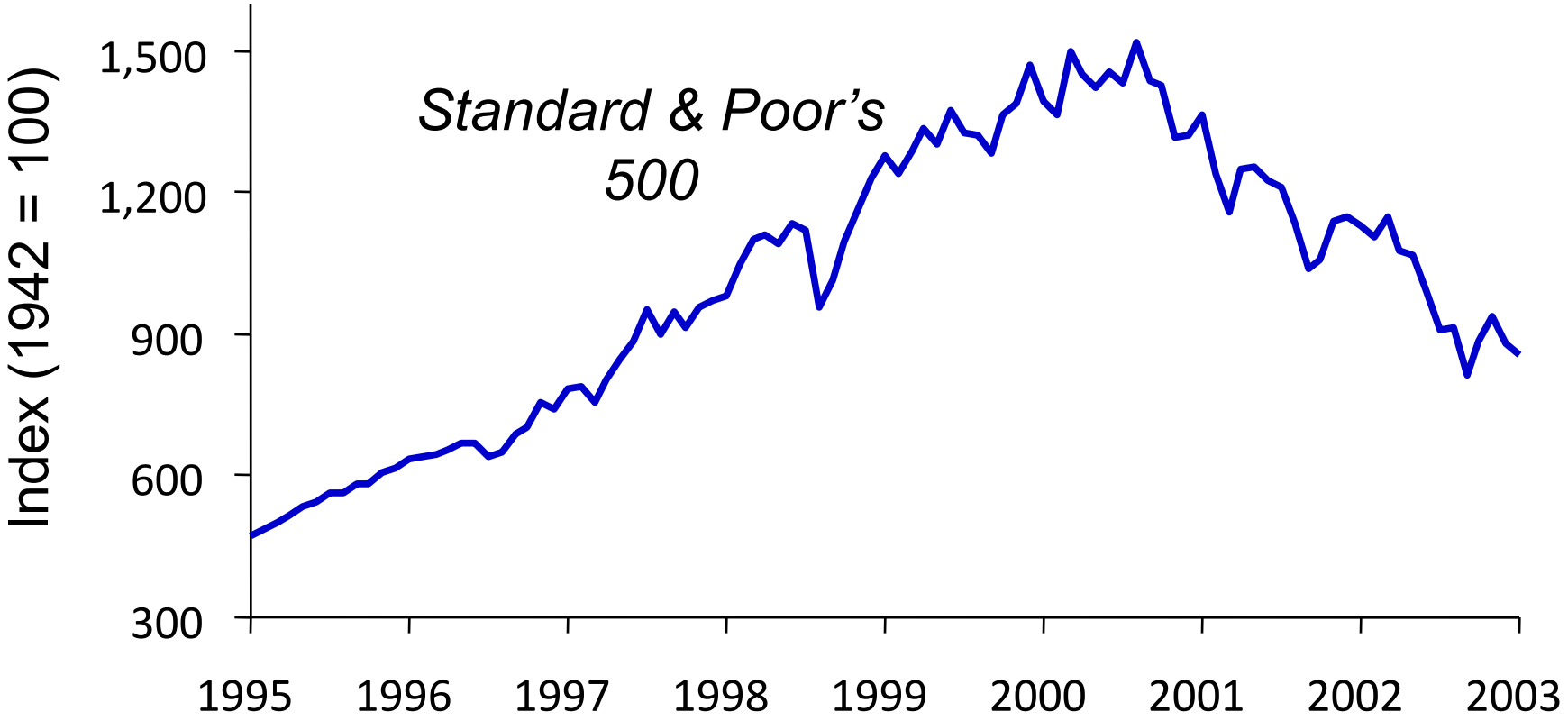
The U.S. recession of 2001

- During 2001:
  - 2.1 million jobs lost,
    unemployment rose from 3.9% to 5.8%.
  - GDP growth slowed to 0.8%
    (compared to 3.9% average annual growth during 1994–2000).

CASE STUDY:

The U.S. recession of 2001

Causes: 1) Stock market decline $\Rightarrow \downarrow C$



CASE STUDY:

The U.S. recession of 2001

Causes: 2) 9/11

- increased uncertainty
- fall in consumer & business confidence
- result: lower spending, *IS* curve shifted left

Causes: 3) Corporate accounting scandals

- Enron, WorldCom, *etc*.
- reduced stock prices, discouraged investment

CASE STUDY:

The U.S. recession of 2001

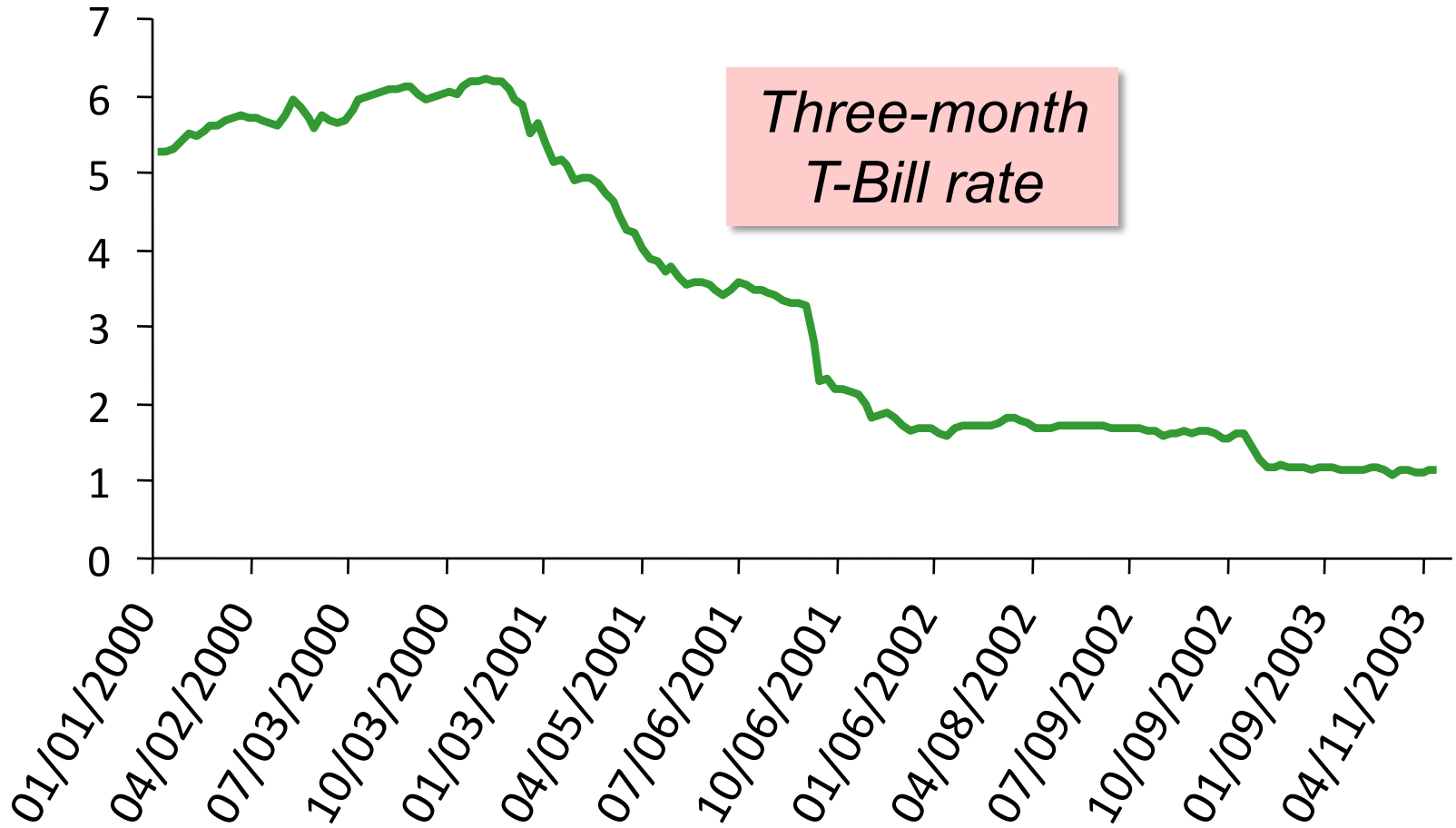
Fiscal policy response: shifted *IS* curve right

- tax cuts in 2001 and 2003
- spending increases
  - airline industry bailout
  - NYC reconstruction
  - Afghanistan war

CASE STUDY:

The U.S. recession of 2001

Monetary policy response: shifted *LM* curve right



What is the Fed's policy instrument?

- The news media commonly report the Fed's policy changes as interest rate changes, as if the Fed has direct control over market interest rates.
- In fact, the Fed **targets** the *federal funds rate*—the interest rate banks charge one another on overnight loans.
- The Fed changes the money supply and shifts the *LM* curve to achieve its target.
- Other short-term rates typically move with the federal funds rate.

What is the Fed's policy instrument?

Why does the Fed target interest rates instead of the money supply?

1) They are easier to measure than the money supply.
2) The Fed might believe that *LM* shocks are more prevalent than *IS* shocks. If so, then targeting the interest rate stabilizes income better than targeting the money supply.
   (See problem 7 on p.353.)

IS-LM and aggregate demand

- So far, we've been using the *IS-LM* model to analyze the short run, when the price level is assumed fixed.
- However, a change in ***P*** would shift *LM* and therefore affect ***Y*.**
- The **aggregate demand curve** (*introduced in Chap. 10*) captures this relationship between ***P*** and ***Y.***

Deriving the *AD* curve

Intuition for slope of *AD* curve:

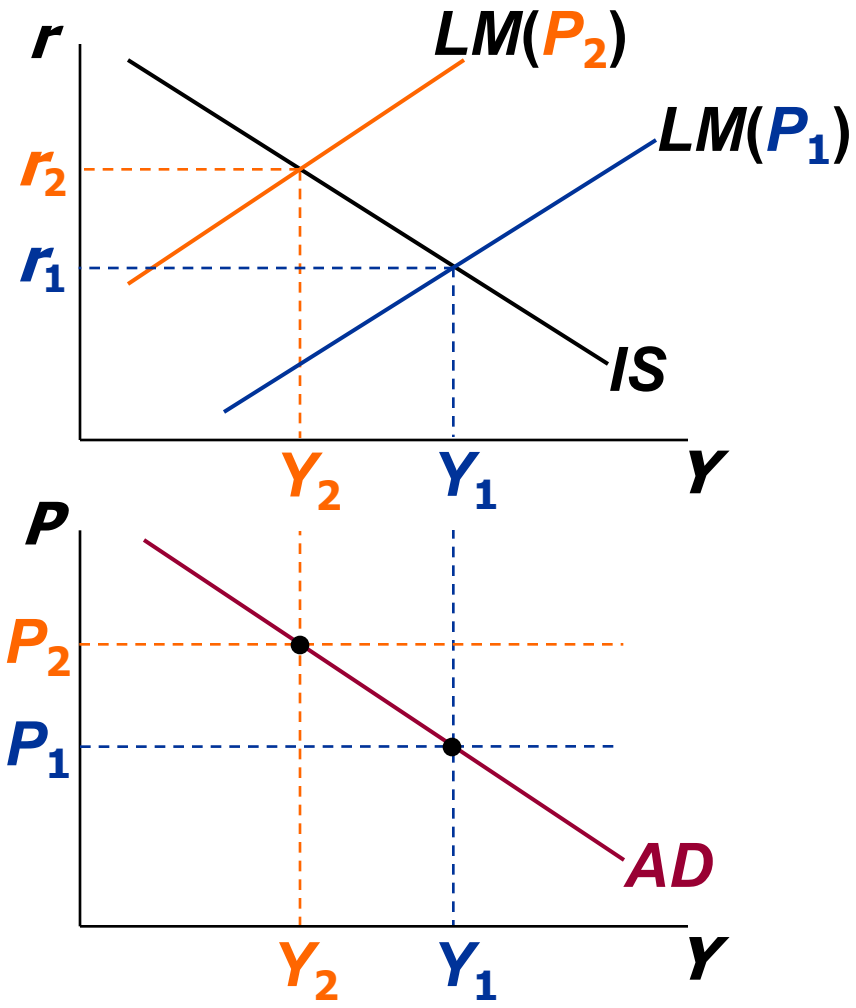
$\uparrow P \Rightarrow \downarrow (M/P)$

$\Rightarrow$ *LM* shifts left

$\Rightarrow \uparrow r$

$\Rightarrow \downarrow I$

$\Rightarrow \downarrow Y$



Monetary policy and the *AD* curve

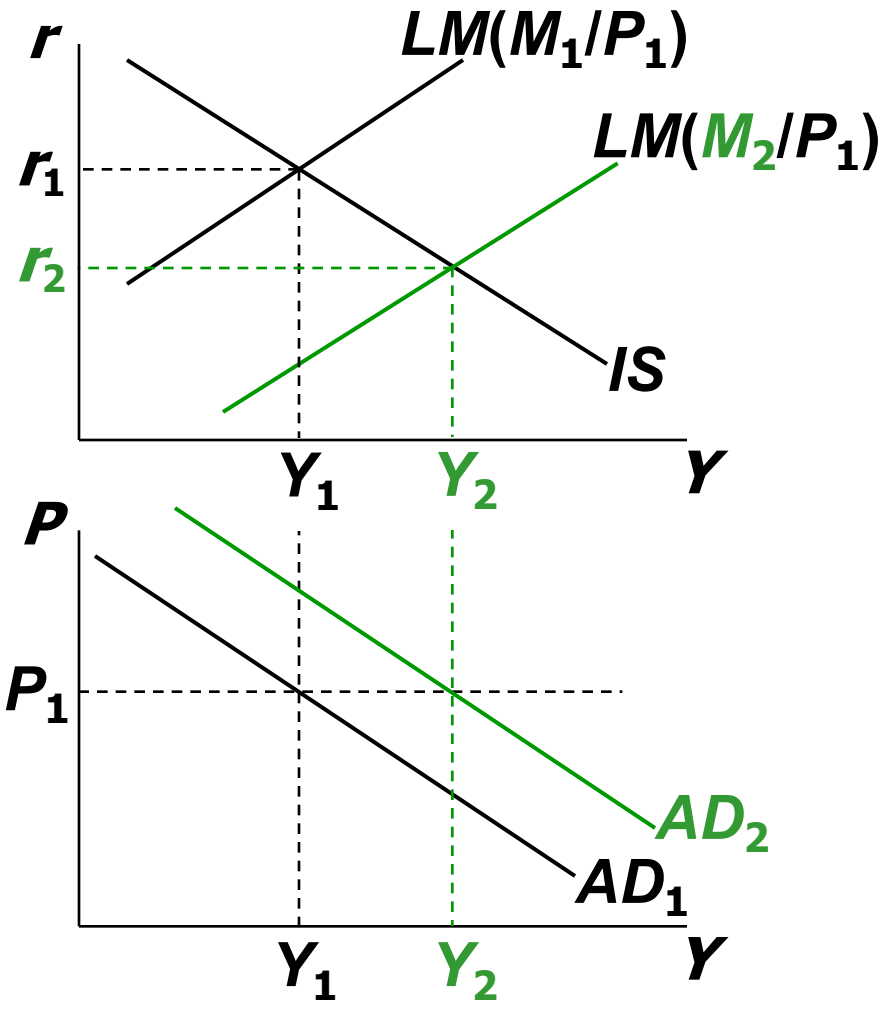
The Fed can increase aggregate demand:

$\uparrow M \Rightarrow LM$ shifts right

$\Rightarrow \downarrow r$

$\Rightarrow \uparrow I$

$\Rightarrow \uparrow Y$ at each value of P



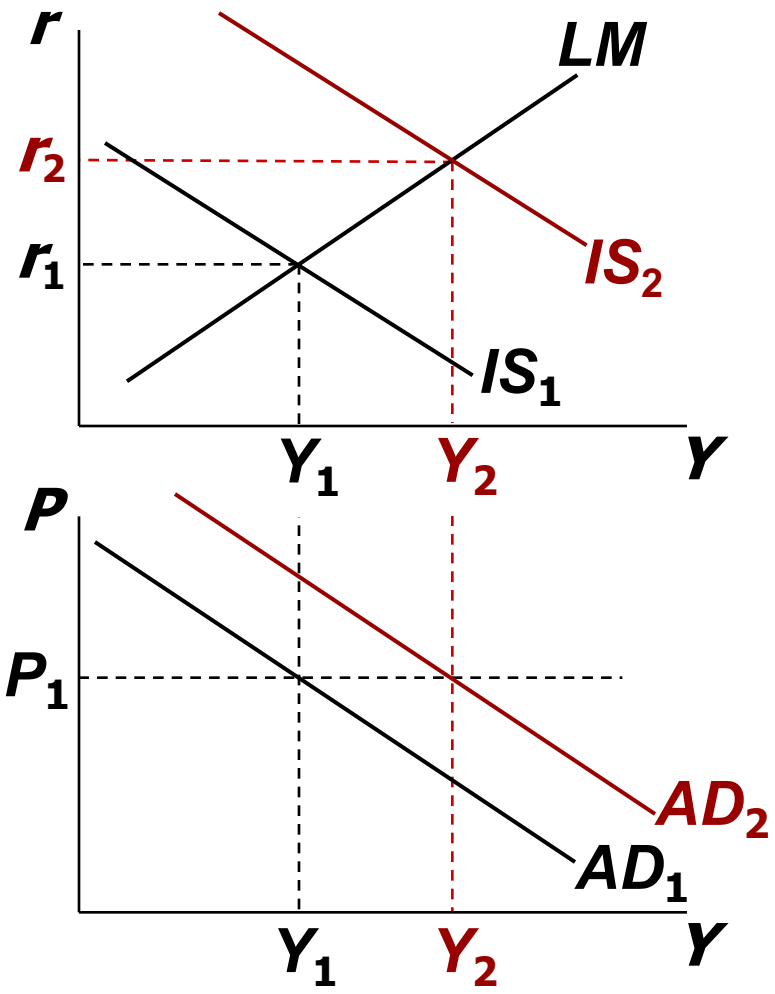
Fiscal policy and the *AD* curve

Expansionary fiscal policy ($\uparrow G$ and/or $\downarrow T$) increases agg. demand:

$\downarrow T \Rightarrow \uparrow C$

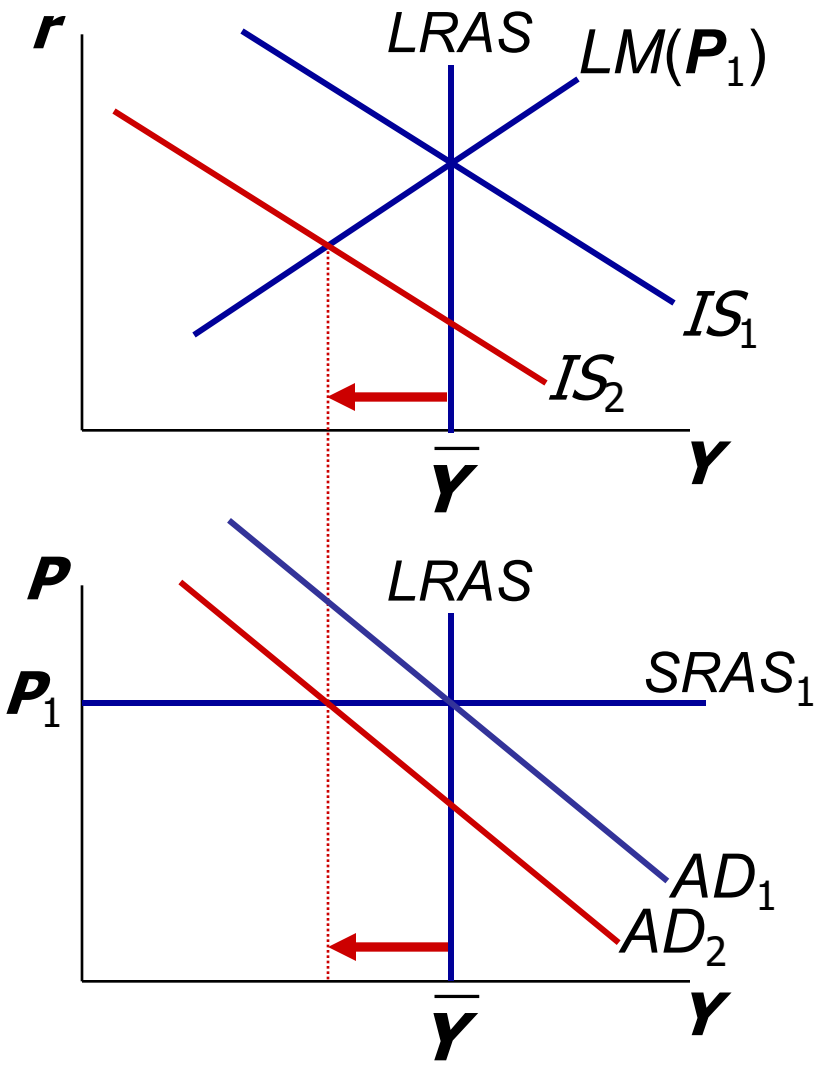
$\Rightarrow$ *IS* shifts right

$\Rightarrow \uparrow Y$ at each value of P



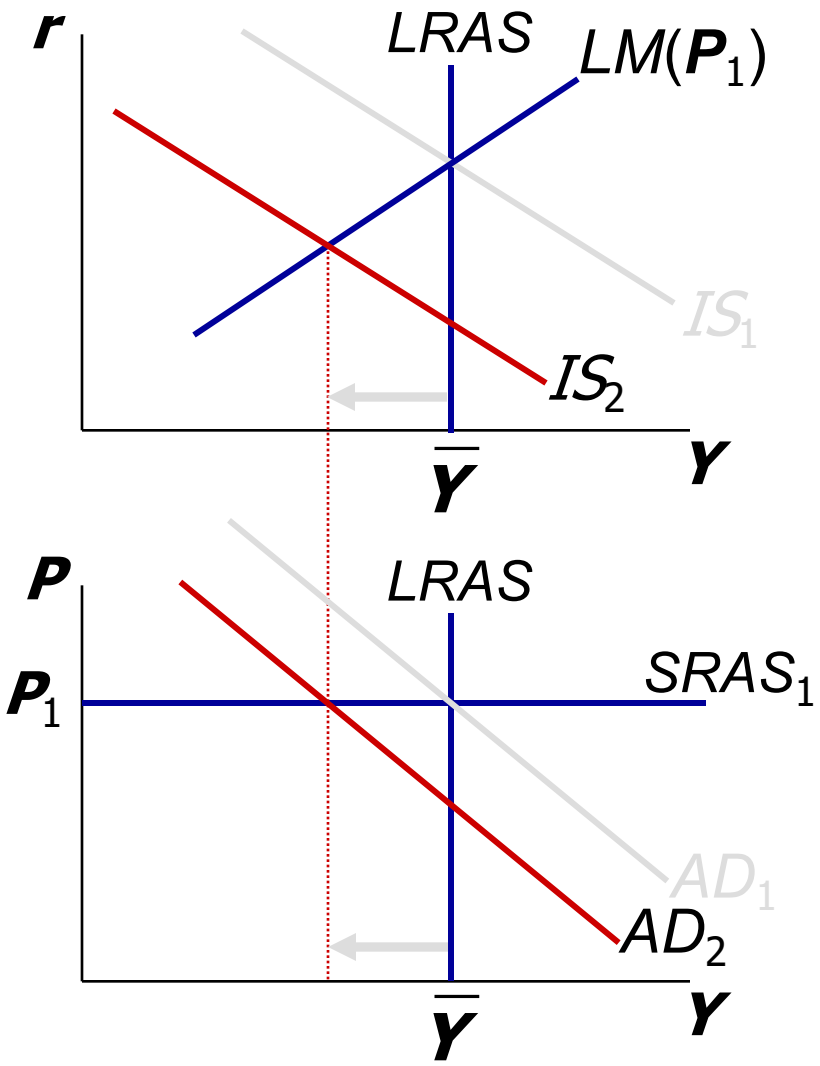
The SR and LR effects of an *IS* shock

A negative *IS* shock shifts *IS* and *AD* left, causing ***Y*** to fall.



The SR and LR effects of an *IS* shock

In the new short-run equilibrium, $Y < \overline{Y}$

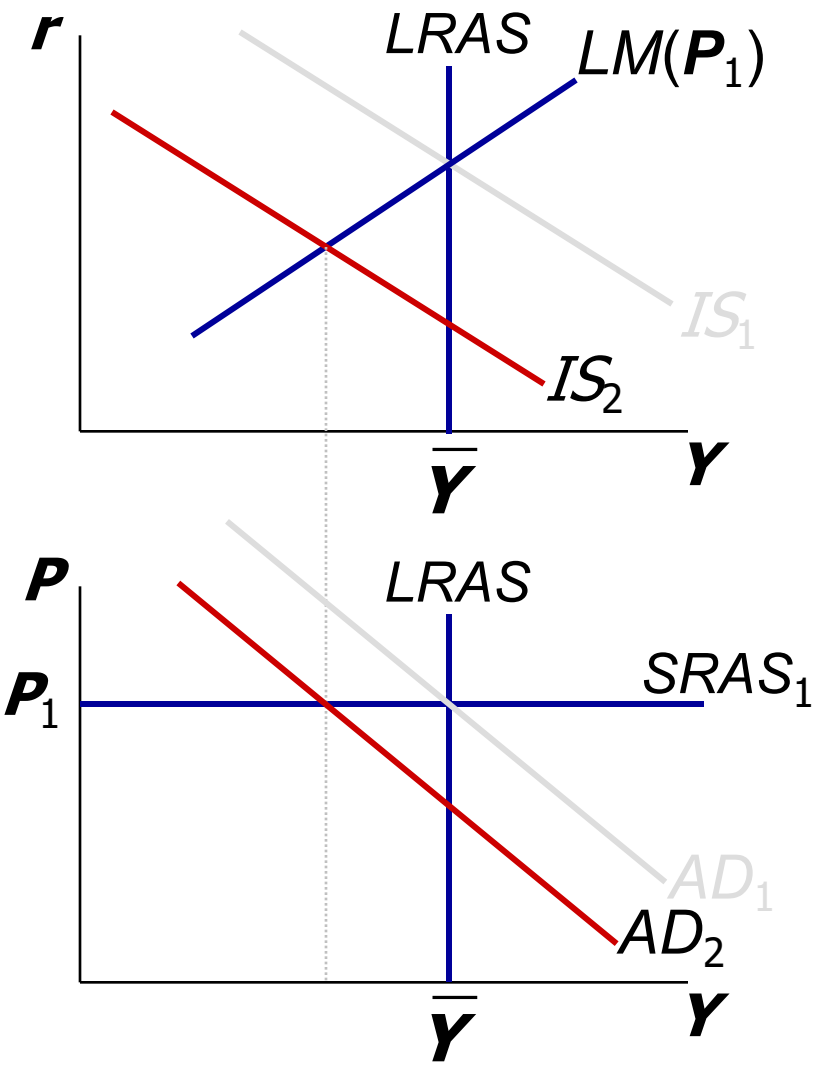


The SR and LR effects of an *IS* shock

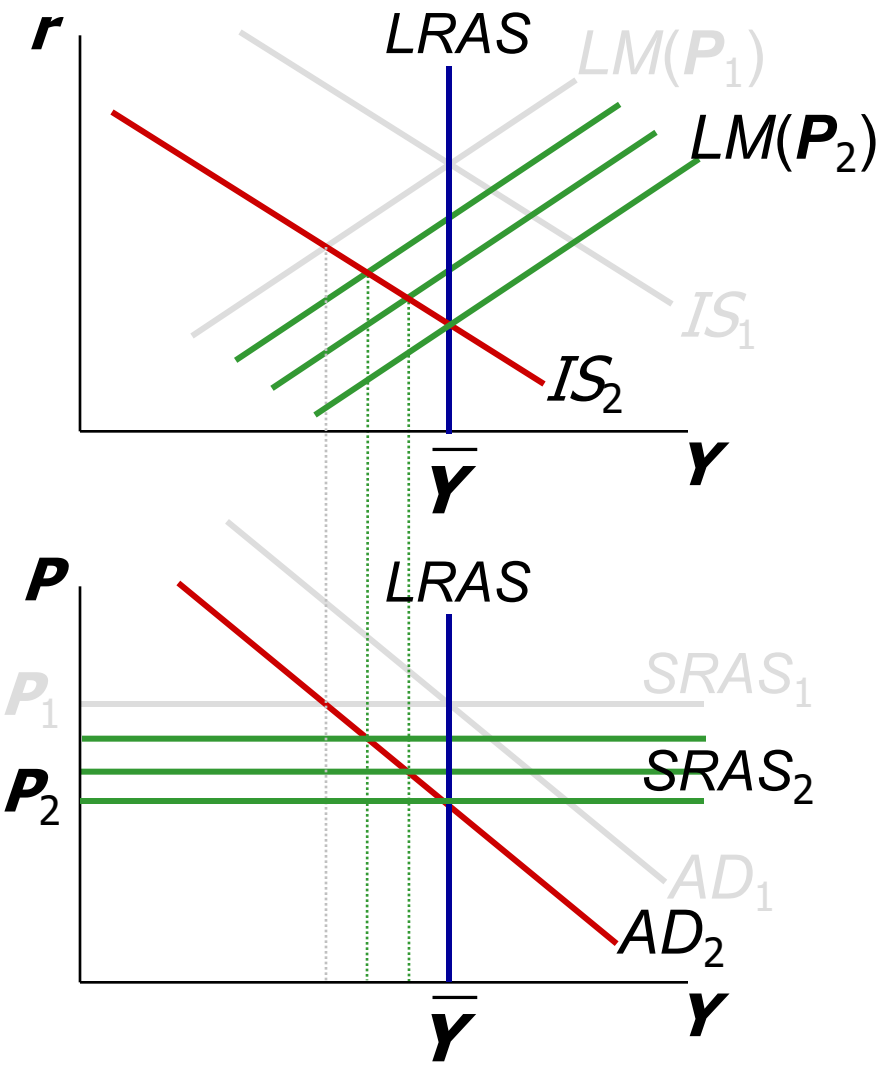
In the new short-run equilibrium, $Y < \overline{Y}$

Over time, ***P*** gradually falls, causing:

- *SRAS* to move down
- ***M/P*** to increase, which causes *LM* to move down



The SR and LR effects of an *IS* shock



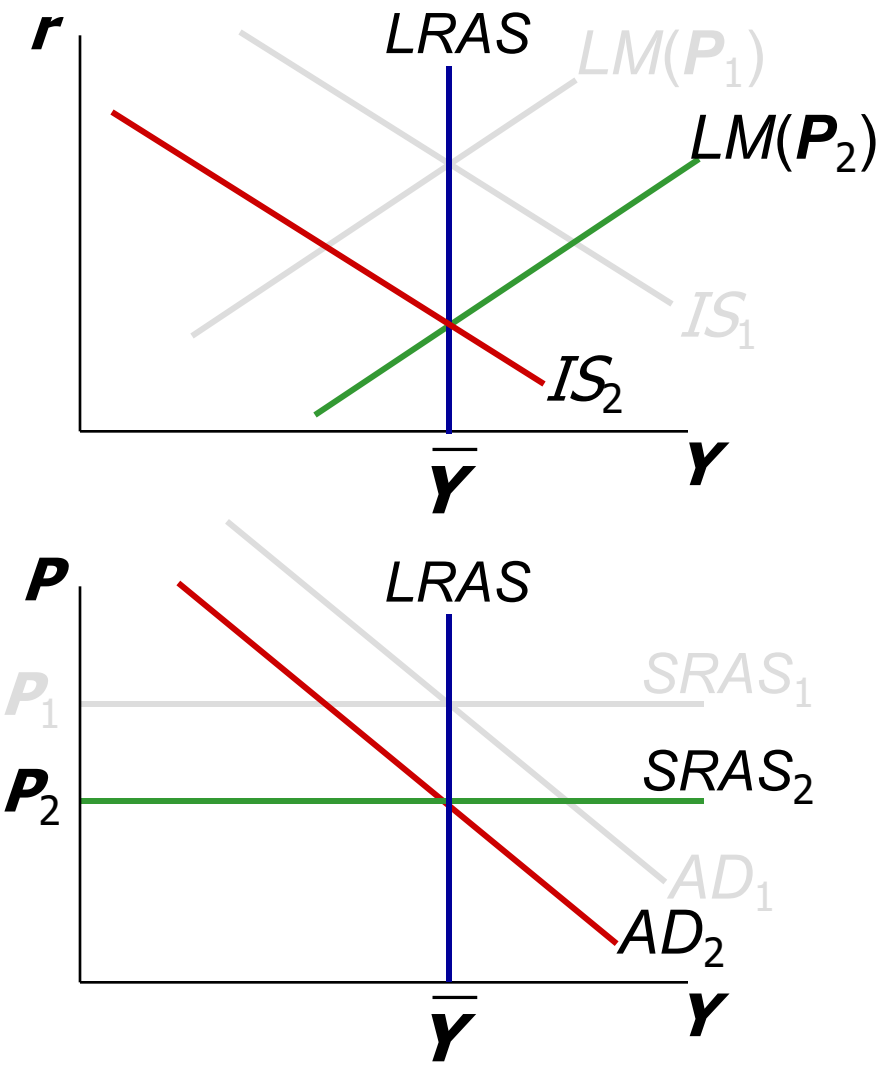
Over time, ***P*** gradually falls, causing:

- *SRAS* to move down
- ***M/P*** to increase, which causes *LM* to move down

The SR and LR effects of an *IS* shock

This process continues until economy reaches a long-run equilibrium with

$$Y = \bar{Y}$$



NOW YOU TRY

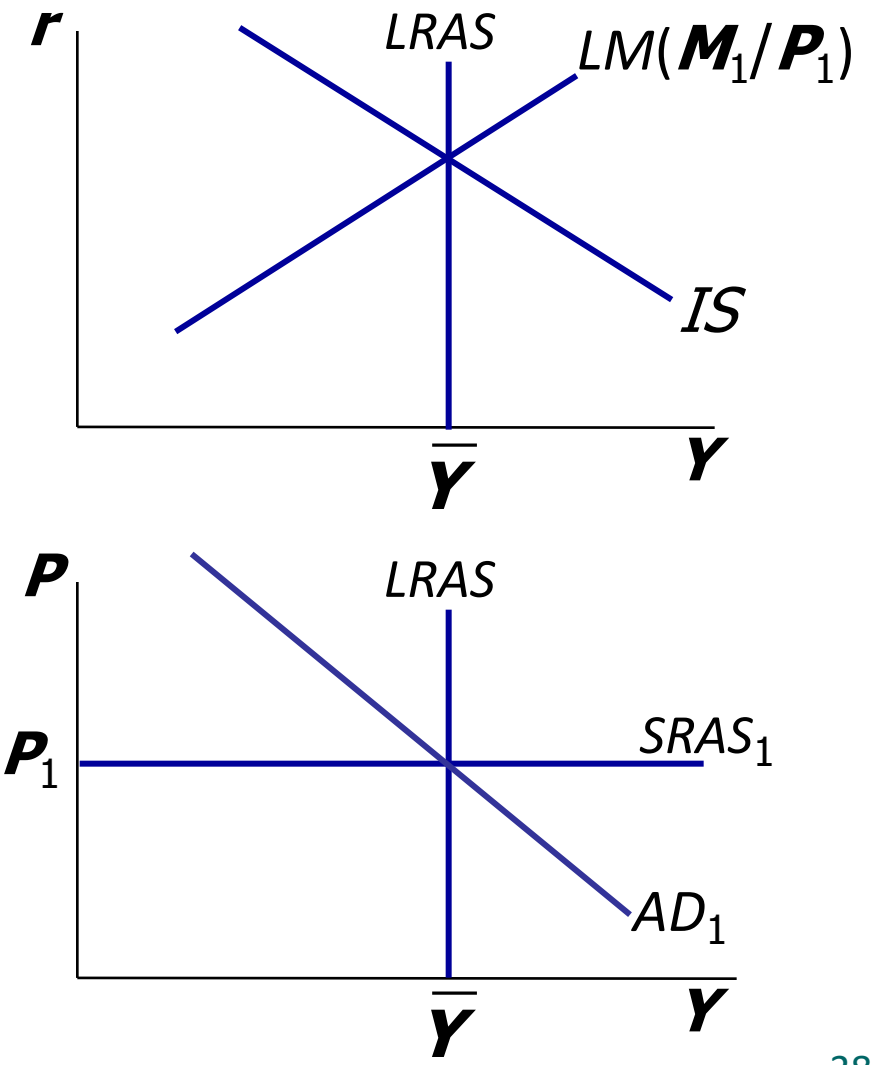
Analyze SR & LR effects of ΔM

a. Draw the *IS-LM* and *AD-AS* diagrams as shown here.

b. Suppose Fed increases ***M***. Show the short-run effects on your graphs.

c. Show what happens in the transition from the short run to the long run.

d. How do the new long-run equilibrium values of the endogenous variables compare to their initial values?

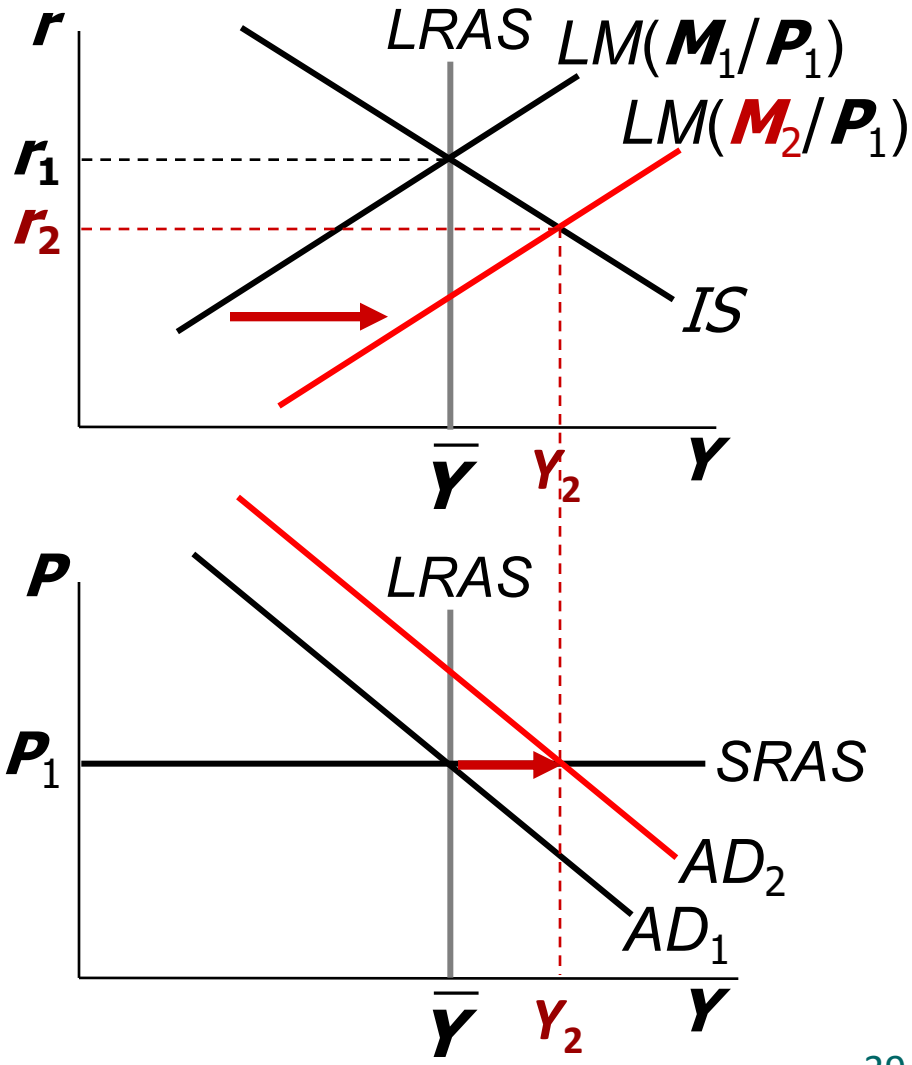


ANSWERS, PART 1

Short-run effects of ΔM

LM and *AD* shift right.

r falls, ***Y*** rises above $\overline{\boldsymbol{Y}}$



Transition from short run to long run

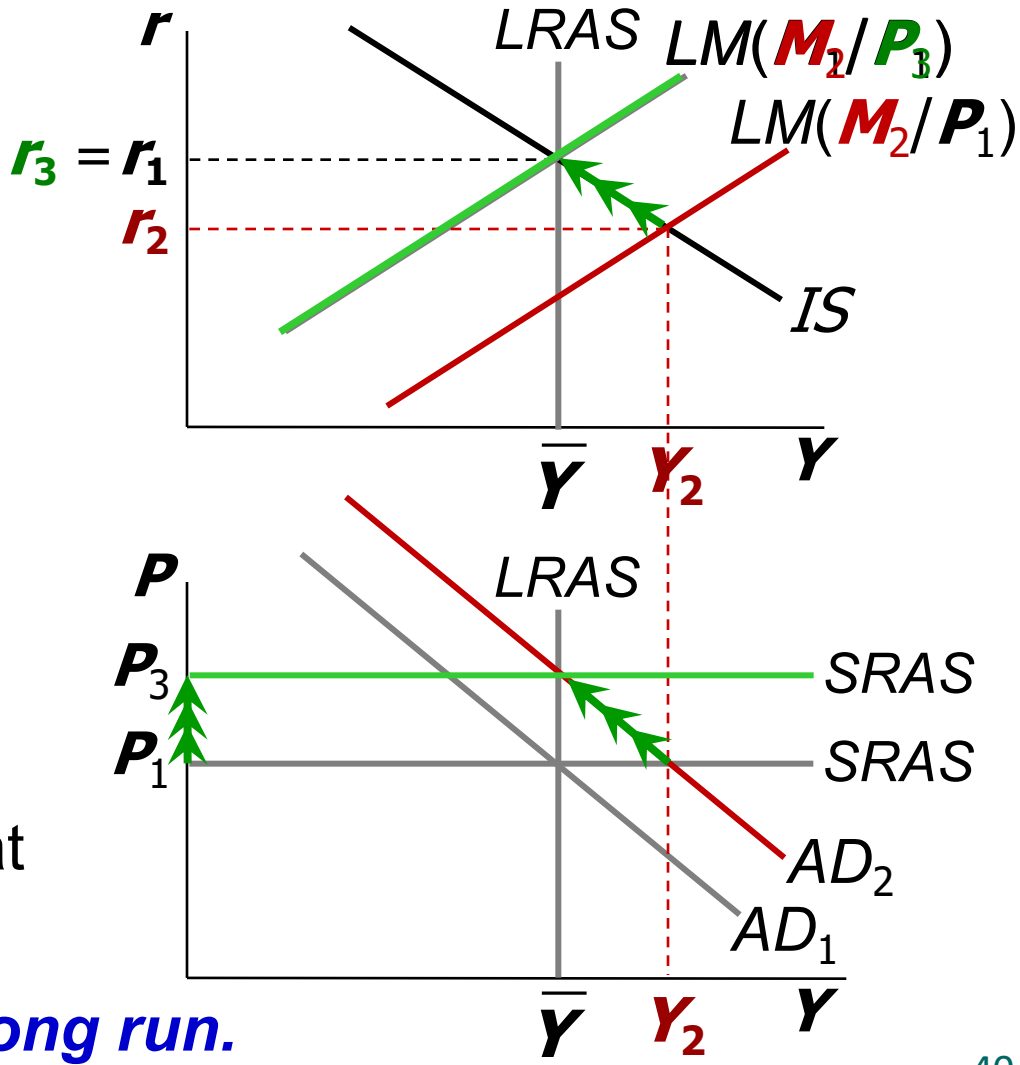
Over time,

- ***P*** rises
- *SRAS* moves upward
- ***M***/***P*** falls
- *LM* moves leftward

New long-run eq'm

- ***P*** higher
- all *real* variables back at their initial values

Money is neutral in the long run.



THE SPENDING HYPOTHESIS:

Shocks to the *IS* curve

- Asserts that the Depression was largely due to an exogenous fall in the demand for goods & services—a leftward shift of the *IS* curve.
- Evidence:
  output and interest rates both fell, which is what a leftward *IS* shift would cause.

THE SPENDING HYPOTHESIS:

Reasons for the *IS* shift

- Stock market crash $\Rightarrow$ exogenous $\downarrow \boldsymbol{C}$
  - Oct 1929–Dec 1929: S&P 500 fell 17%
  - Oct 1929–Dec 1933: S&P 500 fell 71%
- Drop in investment
  - Correction after overbuilding in the 1920s.
  - Widespread bank failures made it harder to obtain financing for investment.
- Contractionary fiscal policy
  - Politicians raised tax rates and cut spending to combat increasing deficits.

THE MONEY HYPOTHESIS:

A shock to the *LM* curve

- Asserts that the Depression was largely due to huge fall in the money supply.
- Evidence:
  *M*1 fell 25% during 1929–33.
- But, two problems with this hypothesis:
  - ***P*** fell even more, so ***M***/***P*** actually rose slightly during 1929–31.
  - nominal interest rates fell, which is the opposite of what a leftward *LM* shift would cause.

THE MONEY HYPOTHESIS AGAIN:

The effects of falling prices

- Asserts that the severity of the Depression was due to a huge deflation:

  P fell 25% during 1929–33.

- This deflation was probably caused by the fall in ***M***, so perhaps money played an important role after all.
- In what ways does a deflation affect the economy?

THE MONEY HYPOTHESIS AGAIN:

The effects of falling prices

- The stabilizing effects of deflation:
- $\downarrow \boldsymbol{P} \Rightarrow \uparrow(\boldsymbol{M/P}) \Rightarrow LM$ shifts right $\Rightarrow \uparrow \boldsymbol{Y}$
- **Pigou effect**:

$\downarrow \boldsymbol{P}$ $\Rightarrow \uparrow(\boldsymbol{M/P})$

$\Rightarrow$ consumers' wealth $\uparrow$

$\Rightarrow \uparrow \boldsymbol{C}$

$\Rightarrow IS$ shifts right

$\Rightarrow \uparrow \boldsymbol{Y}$

THE MONEY HYPOTHESIS AGAIN:

The effects of falling prices

- The destabilizing effects of unexpected deflation: **debt-deflation theory**

↓***P*** (if unexpected)

⇒ transfers purchasing power from borrowers to lenders

⇒ borrowers spend less, lenders spend more

⇒ if borrowers' propensity to spend is larger than lenders', then aggregate spending falls, the *IS* curve shifts left, and ***Y*** falls

Why another Depression is unlikely

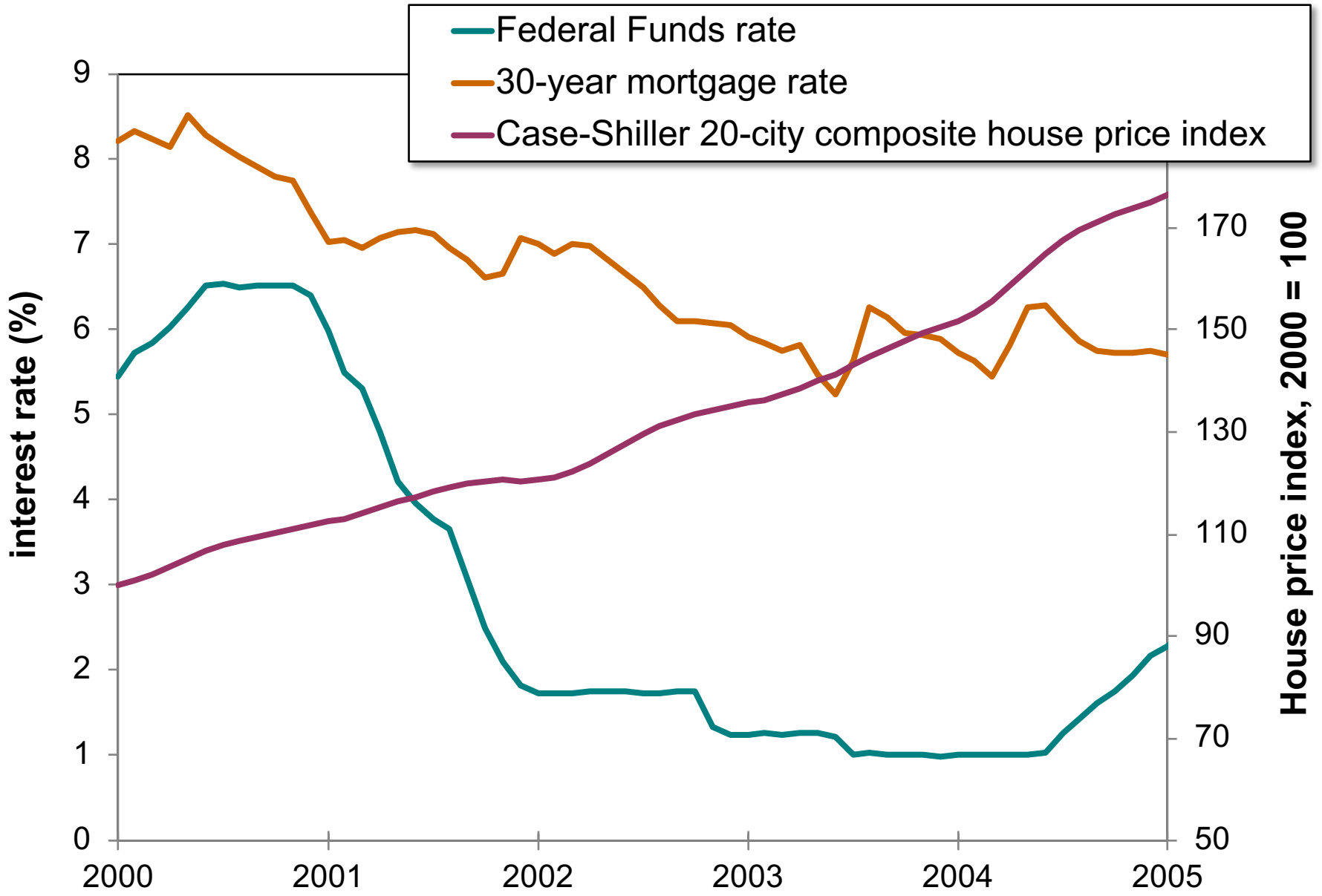
- Policymakers (or their advisers) now know much more about macroeconomics:
  - The Fed knows better than to let ***M*** fall so much, especially during a contraction.
  - Fiscal policymakers know better than to raise taxes or cut spending during a contraction.
- Federal deposit insurance makes widespread bank failures very unlikely.
- Automatic stabilizers make fiscal policy expansionary during an economic downturn.

CASE STUDY

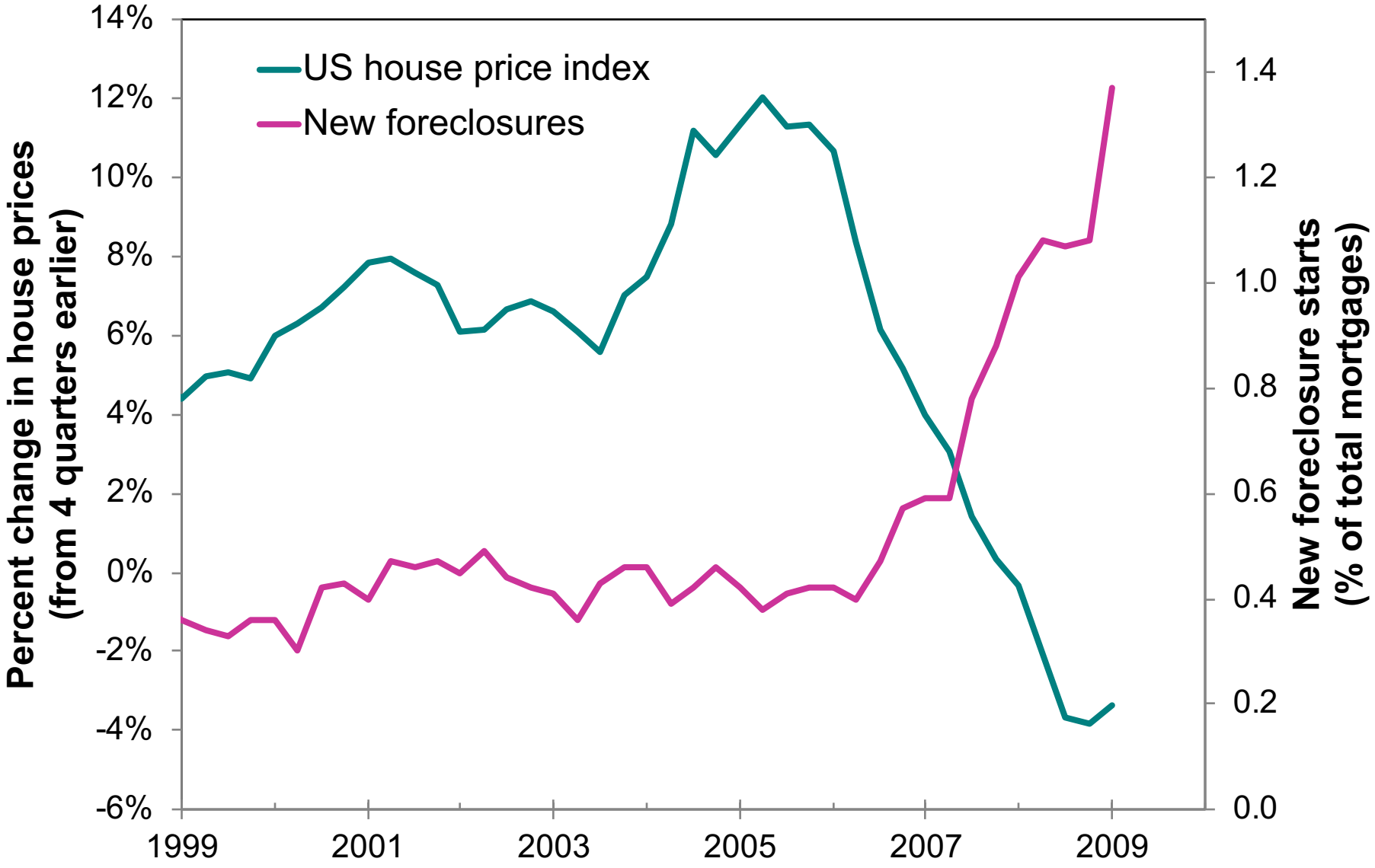
The 2008–09 financial crisis & recession

- 2009: Real GDP fell, u-rate approached 10%
- Important factors in the crisis:
  - early 2000s Federal Reserve interest rate policy
  - subprime mortgage crisis
  - bursting of house price bubble,
    rising foreclosure rates
  - falling stock prices
  - failing financial institutions
  - declining consumer confidence, drop in spending on consumer durables and investment goods

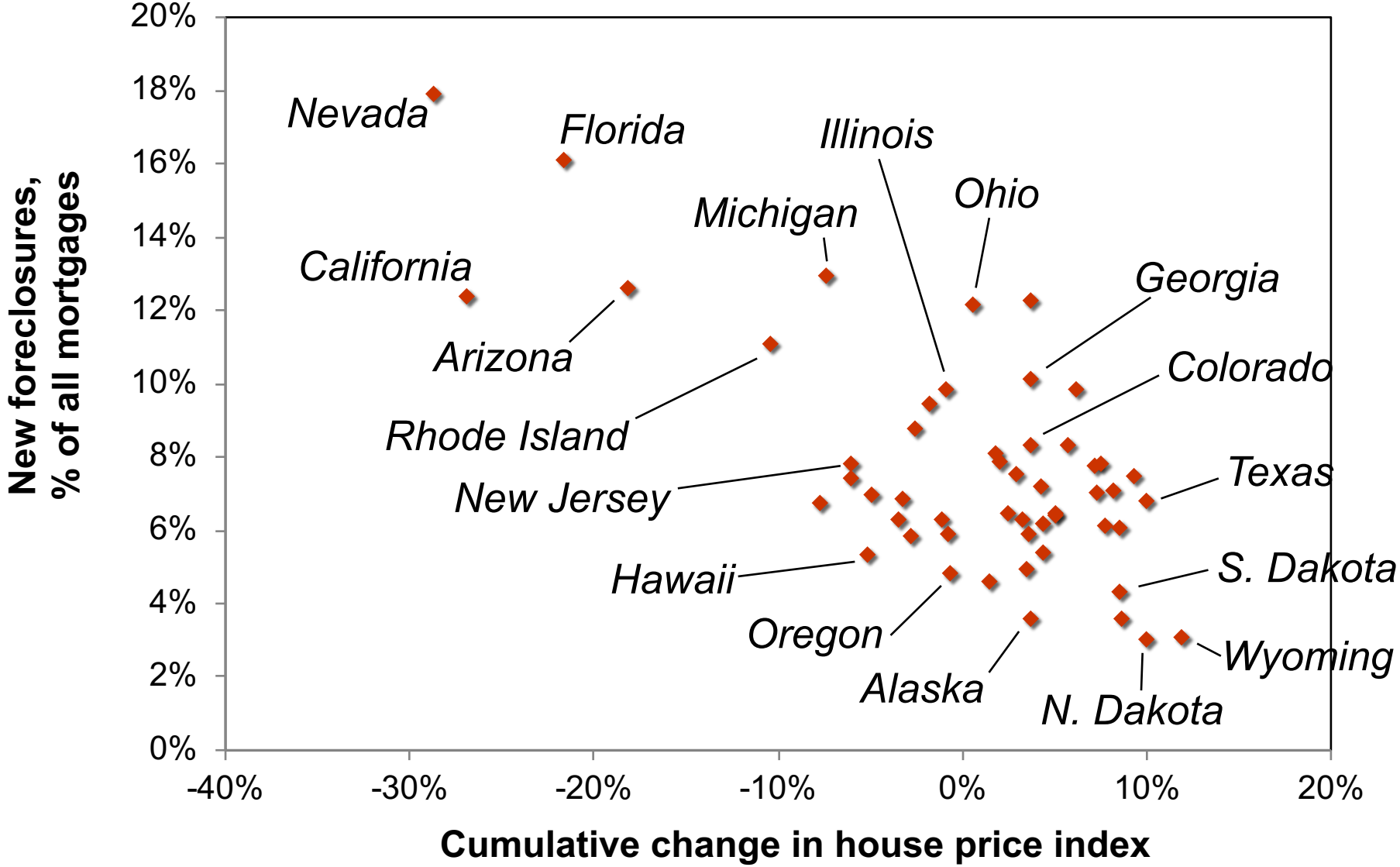
Interest rates and house prices



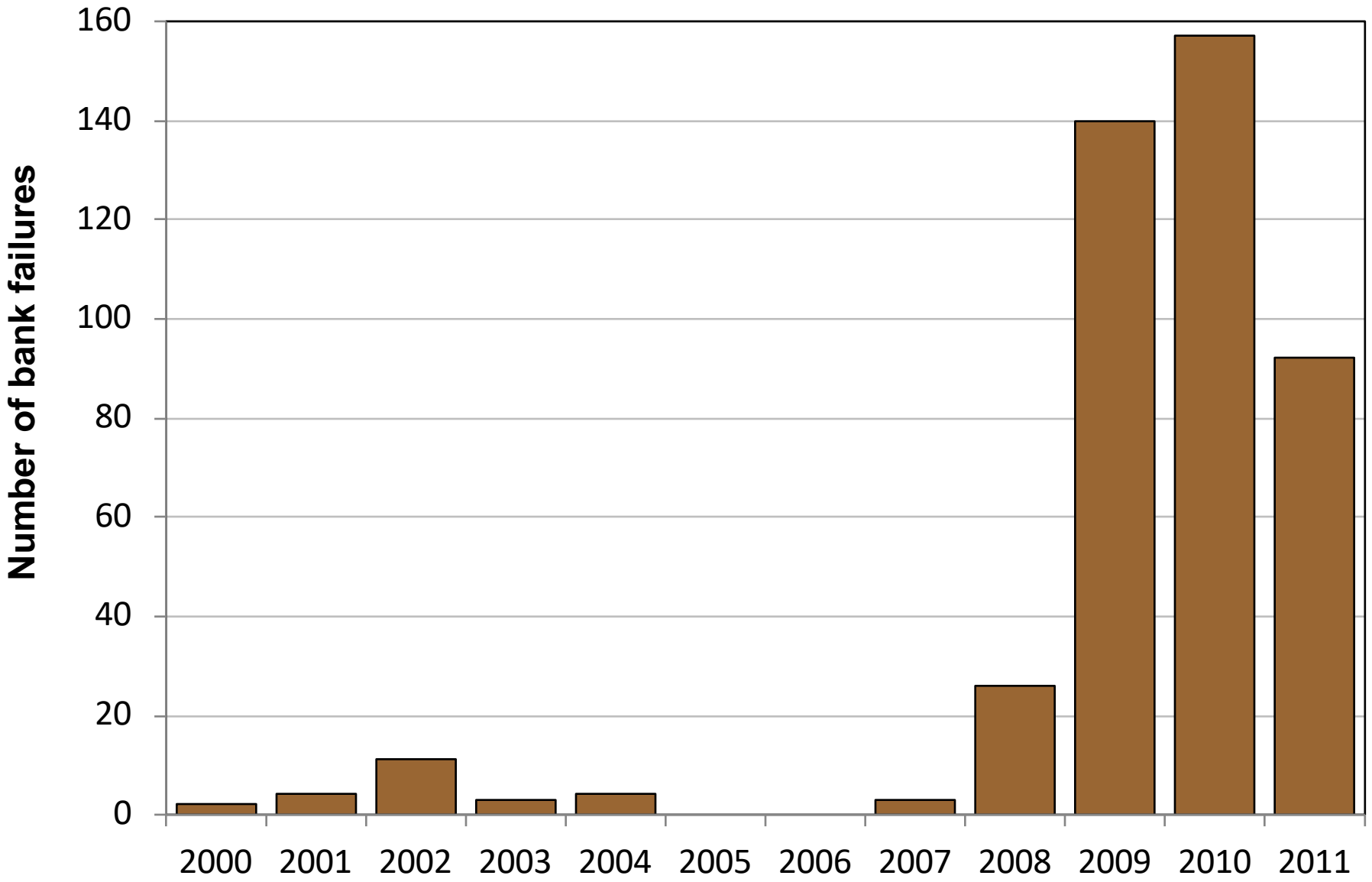
Change in U.S. house price index and rate of new foreclosures, 1999–2009



House price change and new foreclosures, 2006:Q3–2009:Q1

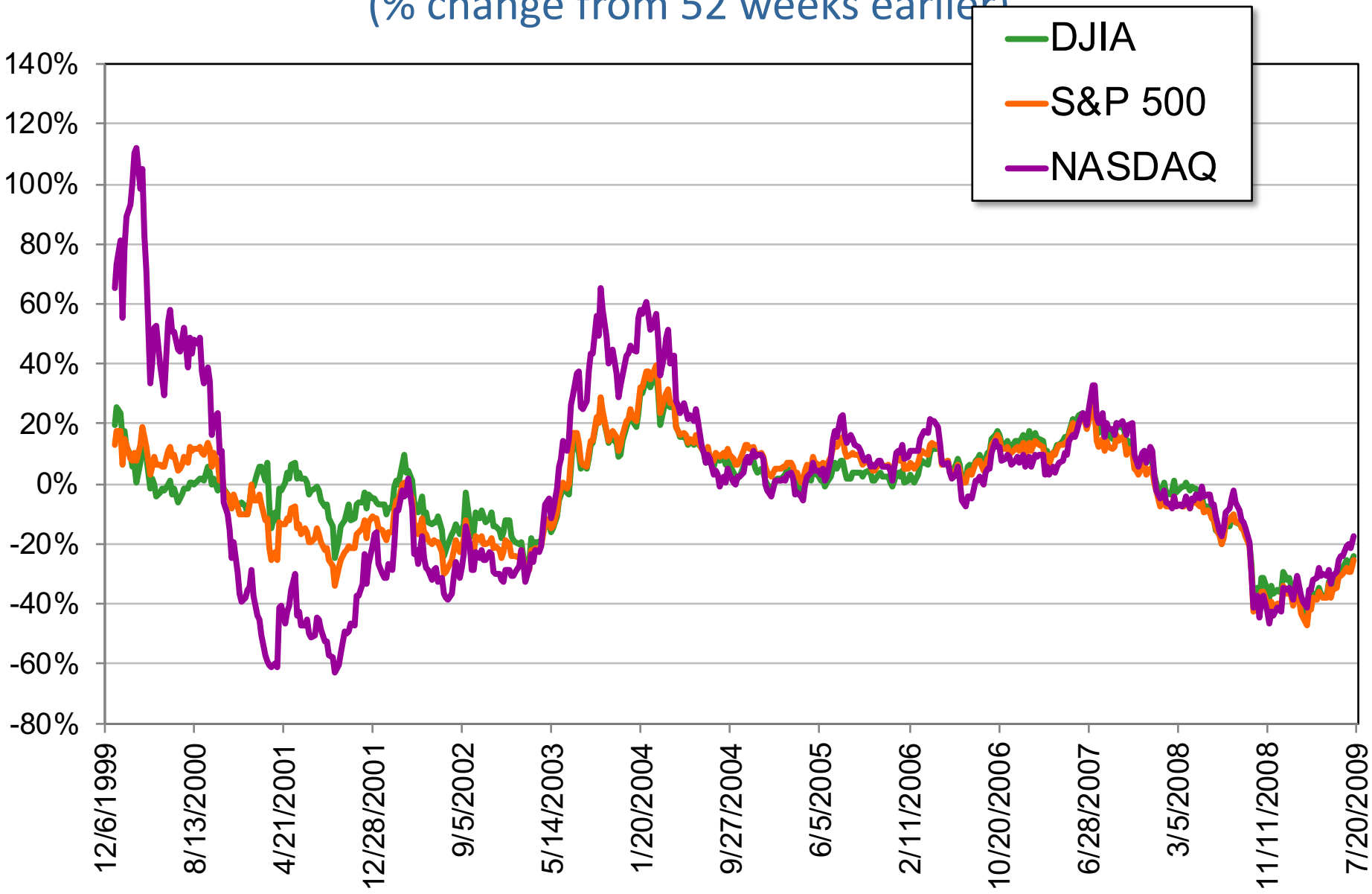


U.S. bank failures by year, 2000–2011

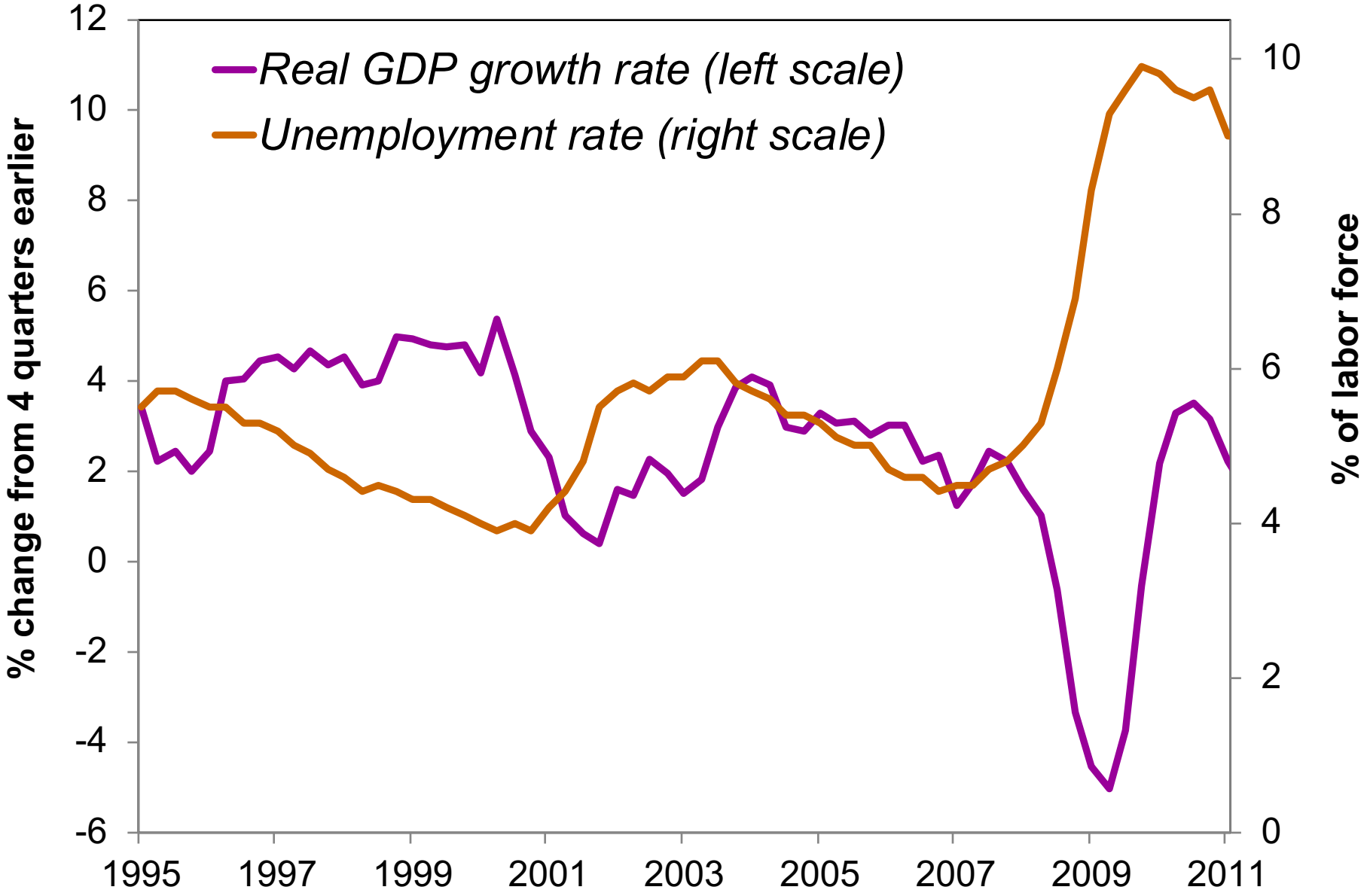


Major U.S. stock indexes

(% change from 52 weeks earlier)



Real GDP growth and unemployment



CHAPTER SUMMARY

1. *IS-LM* model
   - a theory of aggregate demand
   - exogenous: ***M***, ***G***, ***T***,
     P exogenous in short run, ***Y*** in long run
   - endogenous: ***r***,
     Y endogenous in short run, ***P*** in long run
   - *IS* curve: goods market equilibrium
   - *LM* curve: money market equilibrium

CHAPTER SUMMARY

2. *AD* curve
   - shows relation between ***P*** and the *IS-LM* model's equilibrium ***Y***.
   - negative slope because
     $\uparrow \boldsymbol{P} \Rightarrow \downarrow (\boldsymbol{M/P}) \Rightarrow \uparrow \boldsymbol{r} \Rightarrow \downarrow \boldsymbol{I} \Rightarrow \downarrow \boldsymbol{Y}$
   - expansionary fiscal policy shifts *IS* curve right, raises income, and shifts *AD* curve right.
   - expansionary monetary policy shifts *LM* curve right, raises income, and shifts *AD* curve right.
   - *IS* or *LM* shocks shift the *AD* curve.