
ECN 135 Lecture [M] Chapter 24 Money, Banks & Financial Institutions

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03.08.2005

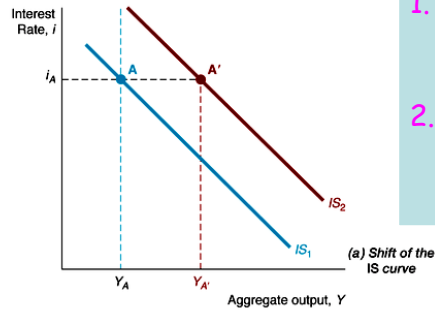
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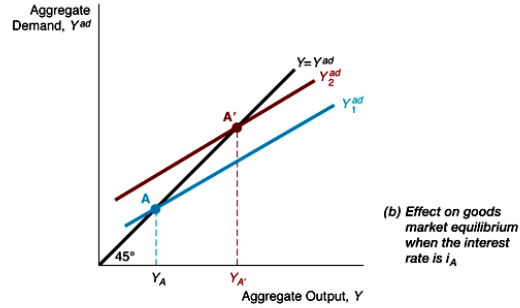
Plan for today

- Monetary and Fiscal Policy in the *ISLM* Model

Shift in the IS Curve



- 1. $C \uparrow$: at given i_A , $y^{ad} \uparrow, Y \uparrow \Rightarrow IS$ shifts right
- 2. Same reasoning when $I \uparrow, G \uparrow, NX \uparrow, T \downarrow$

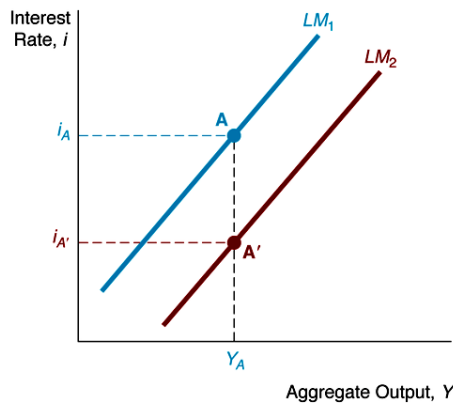


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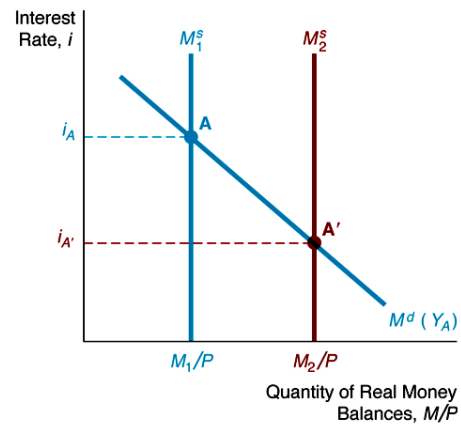
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Shift in the LM Curve from $M^s \uparrow$



(a) Shift of the LM curve



(b) Effect on the market for money when aggregate output is constant at Y_A

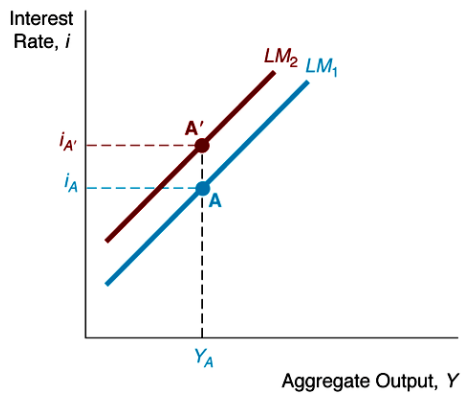
1. $M^s \uparrow$: at given Y_A , $i \downarrow$ in panel (b) and (a) \Rightarrow LM shifts to the right

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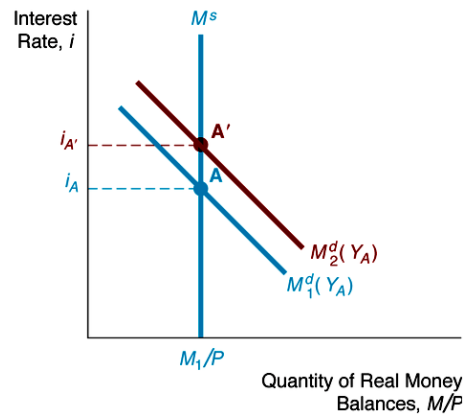
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Shift in the LM Curve from $M^d \uparrow$



(a) Shift in the LM curve



(b) Effect on the market for money when aggregate output is constant at Y_A

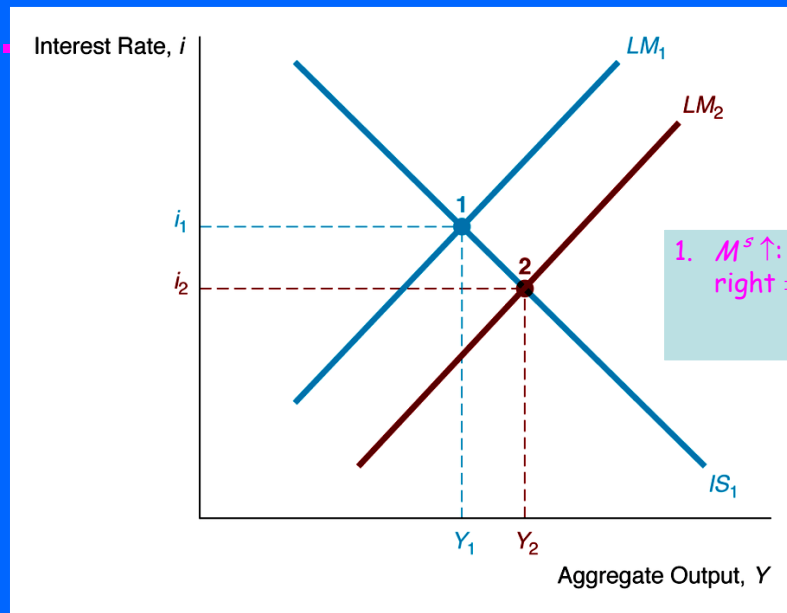
1. $M^d \uparrow$: at given Y_A , $i \uparrow$ in panel (b) and (a) \Rightarrow LM shifts to the left

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Response to an Increase in M^s

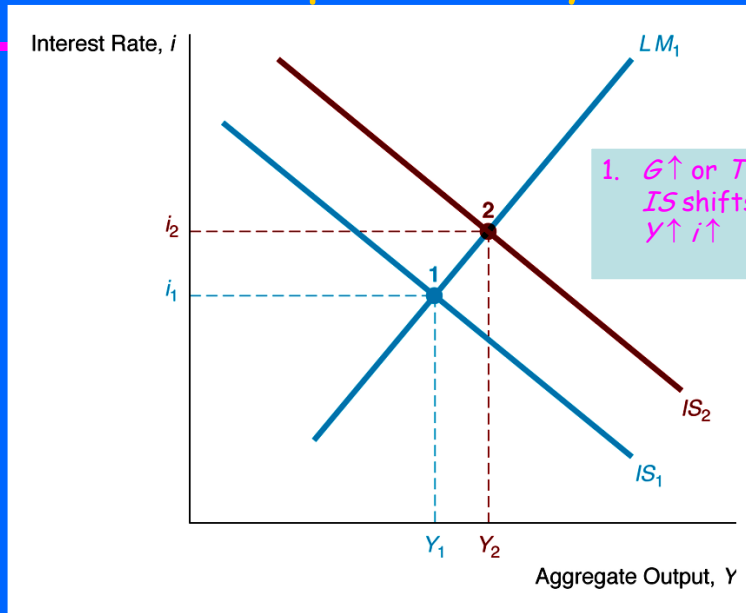


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Response to Expansionary Fiscal Policy






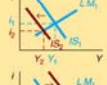



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Summary: Factors that Shift IS and LM Curves

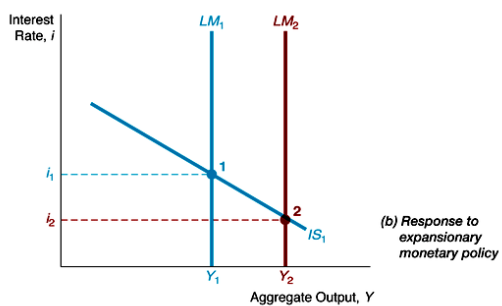
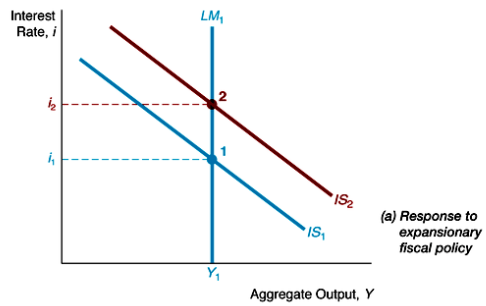
SUMMARY Table 1 Effects from Factors That Shift the IS and LM Curves

Factor	Autonomous Change in Factor	Response	Reason	
Consumer expenditure C	\uparrow	$Y \uparrow, i \uparrow$	$C \uparrow \Rightarrow Y^{ad} \uparrow \Rightarrow$ IS shifts right	
Investment I	\uparrow	$Y \uparrow, i \uparrow$	$I \uparrow \Rightarrow Y^{ad} \uparrow \Rightarrow$ IS shifts right	
Government spending G	\uparrow	$Y \uparrow, i \uparrow$	$G \uparrow \Rightarrow Y^{ad} \uparrow \Rightarrow$ IS shifts right	
Taxes T	\uparrow	$Y \downarrow, i \downarrow$	$T \uparrow \Rightarrow C \downarrow \Rightarrow Y^{ad} \downarrow \Rightarrow$ IS shifts left	
Net exports NX	\uparrow	$Y \uparrow, i \uparrow$	$NX \uparrow \Rightarrow Y^{ad} \uparrow \Rightarrow$ IS shifts right	
Money supply M^s	\uparrow	$Y \uparrow, i \downarrow$	$M^s \uparrow \Rightarrow i \downarrow \Rightarrow$ LM shifts right	
Money demand M^d	\uparrow	$Y \downarrow, i \uparrow$	$M^d \uparrow \Rightarrow i \uparrow \Rightarrow$ LM shifts left	

Note: Only increases (\uparrow) in the factors are shown. The effect of decreases in the factors would be the opposite of these indicated in the "Response" column.

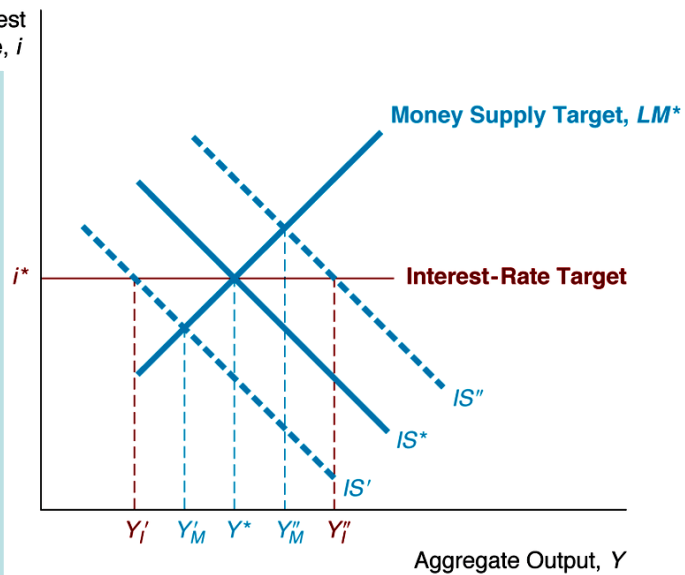
Effectiveness of Monetary and Fiscal Policy

1. M^d is unrelated to $i \Rightarrow i \uparrow, M^d = M^s$ at same $Y \Rightarrow LM$ vertical
 2. Panel (a): $G \uparrow, IS$ shifts right $\Rightarrow i \uparrow, Y$ stays same (complete crowding out)
 3. Panel (b): $M^s \uparrow, Y \uparrow$ so $M^d \uparrow, LM$ shifts right $\Rightarrow i \downarrow, Y \uparrow$
- Conclusion: Less interest sensitive is M^d , more effective is monetary policy relative to fiscal policy*



M^s vs. i Targets with Unstable IS

1. IS unstable: fluctuates from IS' to IS''
 2. i target at i^* : Y fluctuates from Y_I' to Y_I''
 3. M target, $LM = LM^*$: Y fluctuates from Y_M' to Y_M''
 4. Y fluctuation is less with M target
- Conclusion:** If IS curve is more unstable than LM curve, M target is preferred



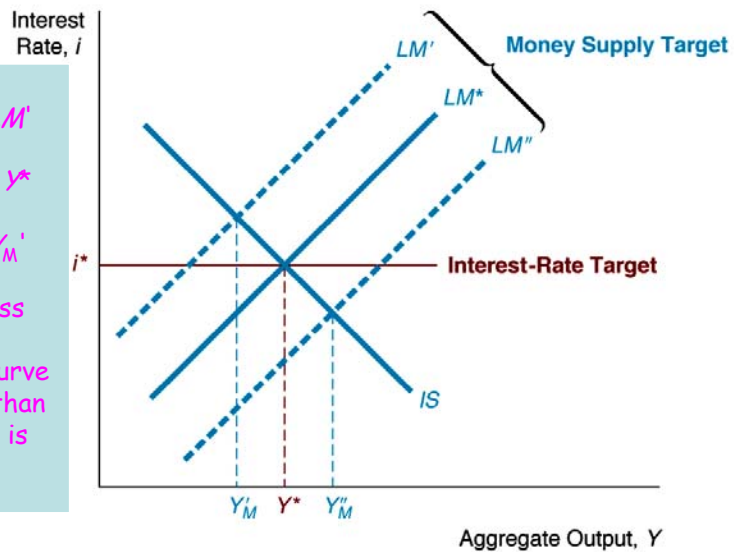
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M^s vs. i Targets: Unstable LM

1. LM unstable: fluctuates from LM' to LM''
 2. i target at i^* : $Y = Y^*$
 3. M target: Y fluctuates from Y_M' to Y_M''
 4. Y fluctuation is less with i target
- Conclusion:** If LM curve is more unstable than IS curve, i target is preferred

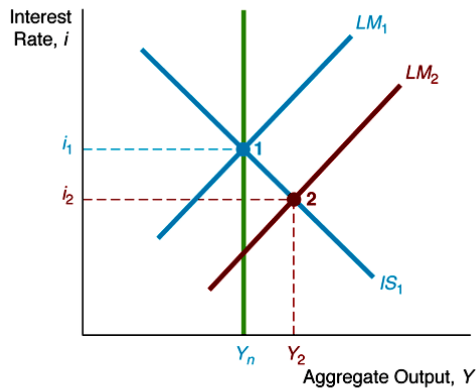


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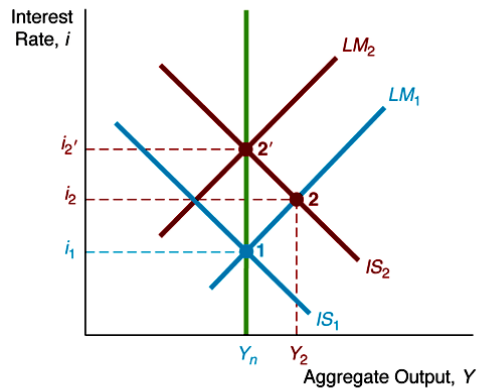
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ISLM Model in the Long Run



(a) Response to a rise in the money supply M



(b) Response to a rise in government spending G

Panel (a)

1. $M^s \uparrow$, LM right to LM_2 , go to point 2, i to i_2 , Y to Y_2
2. Because $Y_2 > Y_n$, $P \uparrow$, $M/P \downarrow$, LM back to LM_1 , go back to point 1

Panel (b)

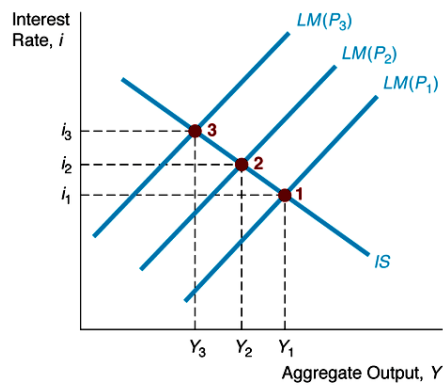
1. $G \uparrow$, IS right to IS_2 , go to point 2 where $i = i_2$ and $Y = Y_2$
2. Because $Y_2 > Y_n$, $P \uparrow$, $M/P \downarrow$, LM left to LM_2 , go to point 2', $i = i_2'$ and $Y = Y_n$

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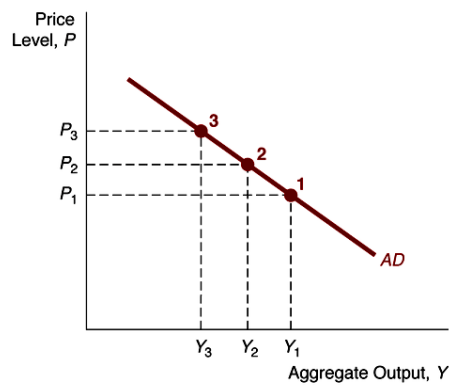
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Deriving AD Curve



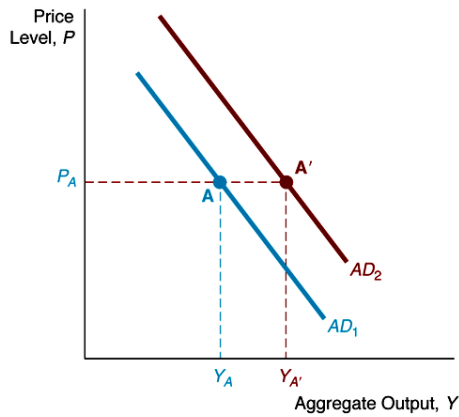
(a) ISLM diagram



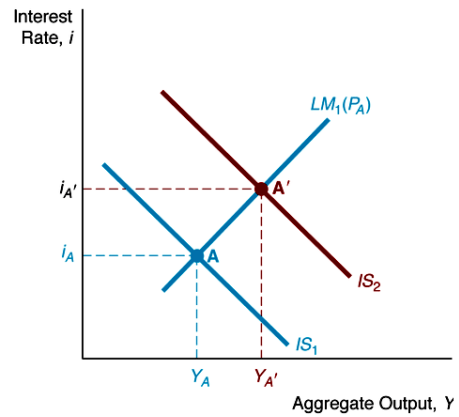
(b) Aggregate demand curve

$P \uparrow, M/P \downarrow, LM$ shifts in, $Y \downarrow$
Points 1, 2, 3

Shift in AD from Shift in IS



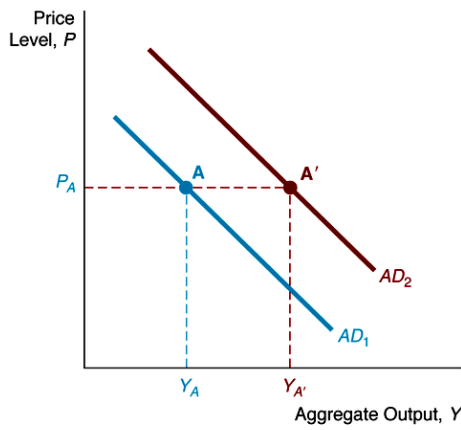
(a) Shift in AD



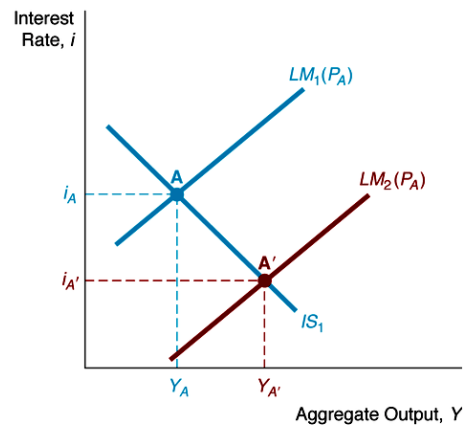
(b) Shift in IS

At given P_A , IS shifts right: $Y \uparrow$ in panel (b) $\Rightarrow AD$ shifts right in panel (a)

Shift in AD from Shift in LM



(a) Shift in AD



(b) Shift in LM

At given P_A , LM shifts right: $Y \uparrow$ in panel (b) $\Rightarrow AD$ shifts right in panel (a)

Next Lecture

- Next lecture ISLM model
- Your preparation: read [M] Ch 25

Summary of Today

- Have a Nice Night