Aggregate Demand II: Applying the IS-LM Model

Modified for ECON 2204
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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.

\[
Y = C(Y - T) + I(r) + G
\]

The *LM* curve represents money market equilibrium.

\[
\frac{\bar{M}}{\bar{P}} = L(r, Y)
\]

The intersection determines the unique combination of $Y$ and $r$ that satisfies equilibrium in both markets.
Policy analysis with the *IS-LM* model

\[ Y = C(Y - \bar{T}) + I(r) + \bar{G} \]
\[ \frac{\bar{M}}{\bar{P}} = L(r, Y) \]

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 \((1-\text{MPC})\) of the tax cut, so the initial boost in spending is smaller for \(\Delta T\) than for an equal \(\Delta G\)... and the IS curve shifts by

\[
\frac{-\text{MPC}}{1-\text{MPC}} \Delta T
\]

...so the effects on \(r\) and \(Y\) are smaller for \(\Delta T\) than for an equal \(\Delta G\).
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 \((M, G, \text{ and } T)\) 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 $\Delta G$ 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:

\[ \Delta Y = Y_2 - Y_1 \]

\[ \Delta r = r_2 - r_1 \]
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:

$$\Delta Y = Y_3 - Y_1$$

$$\Delta r = 0$$
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:

$$\Delta Y = 0$$

$$\Delta r = r_3 - r_1$$
Shocks in the IS-LM model

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

Examples:

- stock market boom or crash
  - change in households’ wealth
  - \( \Delta C \)
- change in business or consumer confidence or expectations
  - \( \Delta I \) and/or \( \Delta C \)
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.
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)
$LM$ 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 → ↓C

![Graph showing the Standard & Poor's 500 index from 1995 to 2003. The index starts at around 300 in 1995 and reaches a peak around 2000, then drops significantly in 2001.]
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

Three-month T-Bill rate

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 8 on p.364.) p. 361
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 \textit{(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:

$\uparrow M \rightarrow LM \text{ shifts right}$

$\rightarrow \downarrow r$

$\rightarrow \uparrow I$

$\rightarrow \uparrow Y \text{ at each value of } P$
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 $P$
**IS-LM and AD-AS in the short run & long run**

*Recall from Chapter 10:* The force that moves the economy from the short run to the long run is the gradual adjustment of prices.

<table>
<thead>
<tr>
<th>In the short-run equilibrium, if</th>
<th>then over time, the price level will</th>
</tr>
</thead>
<tbody>
<tr>
<td>$Y &gt; \bar{Y}$</td>
<td>rise</td>
</tr>
<tr>
<td>$Y &lt; \bar{Y}$</td>
<td>fall</td>
</tr>
<tr>
<td>$Y = \bar{Y}$</td>
<td>remain constant</td>
</tr>
</tbody>
</table>
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, $Y < \bar{Y}$
The SR and LR effects of an IS shock

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

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 \( Y = \bar{Y} \)
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 $\Delta M$

$LM$ and $AD$ shift right.

$r$ falls, $Y$ rises above $\bar{Y}$
ANSWERS, PART 2

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 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 reduced consumption
  - 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 rising 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:
  \[ P \downarrow \rightarrow (M/P) \uparrow \rightarrow LM \text{ shifts right} \rightarrow Y \uparrow \]

- Pigou effect:
  \[ P \downarrow \rightarrow (M/P) \uparrow \]
  \[ \rightarrow \text{consumers’ wealth} \uparrow \]
  \[ \rightarrow C \uparrow \]
  \[ \rightarrow IS \text{ shifts right} \]
  \[ \rightarrow Y \uparrow \]
THE MONEY HYPOTHESIS AGAIN: The effects of falling prices

- The destabilizing effects of expected deflation:

\[ \downarrow E \pi \]
\[ \rightarrow r \uparrow \text{ for each value of } i \]
\[ \rightarrow I \downarrow \text{ because } I = I(r) \]
\[ \rightarrow \text{planned expenditure & agg. demand } \downarrow \]
\[ \rightarrow \text{income & output } \downarrow \]
THE MONEY HYPOTHESIS AGAIN: The effects of falling prices

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

\[ P \text{ (if unexpected)} \]

- transfers purchasing power from borrowers to lenders
- borrowers are now less wealthy, lenders are now more wealthy
- 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
Change in U.S. house price index and rate of new foreclosures, 1999–2009

Cumulative change in house price index vs. New foreclosures, % of all mortgages

- Nevada
- Florida
- Georgia
- Colorado
- Texas
- Alaska
- Wyoming
- Arizona
- California
- New Jersey
- Rhode Island
- Hawaii
- Wisconsin
- Oregon
- S. Dakota
- Illinois
- Michigan
- Ohio
- New Jersey
U.S. bank failures by year, 2000–2011
Consumer sentiment and growth in consumer durables and investment spending

Consumer Sentiment Index, 1966 = 100

% change from four quarters earlier

Durables
Investment
UM Consumer Sentiment Index
Real GDP growth and unemployment

- Real GDP growth rate (left scale)
- Unemployment rate (right scale)