Scope

- Analysis of policies in IS-LM model
  - Monetary policy
    - Changes in money supply
  - Fiscal policy
    - Changes in government spending
    - Changes in taxes
- Differences in the effects of different policies
- Derivation of the AD curve

Policies in IS-LM

- Two markets in the economy
- Government spending in the goods market
  ⇒ changes in the goods market  [first round effect]
  ⇒ changes in the money market  [cross market effect]
  ⇒ changes in the goods market, again,
  This may go on back and forth  [higher round effects]
- Partial equilibrium: Looking at changes in government spending only in the goods market (i.e. accounting for only the first round effect)
- General equilibrium: Accounting for all cross market effects and all higher round effects back and forth
- IS-LM allows for studying such a general equilibrium
Policy Analysis

- Best way to identify effects of policies is to figure out the shifter of the IS and LM curves
- Any changes related to changes in \((i, Y)\): not autonomous changes to IS and LM curves on an \((i, Y)\) plane
- Only changes NOT related to changes in \((i, Y)\) will shift the IS and LM curves

IS and LM Shifters

- **IS shifters**
  - Changes in \(G\)
  - Changes in \(a\)
  - Changes in \(NX\)
  - Changes in \(I\) that is not related to \(i\) (ex: entrepreneurs suddenly becoming optimistic about the economy and expanding their business activities)

- **LM Shifters**
  - Changes in \(M^S\)
  - Changes in \(M^d\) that is not related to changes in \(i\) or \(Y\) (ex: people suddenly losing confidence in the financial system and holding more money)
Monetary Policy

- Looking at the individual markets
  
  \[ M^* \uparrow \rightarrow i \downarrow \rightarrow [I(i) \uparrow \rightarrow Y^{ad} \text{ shifts up } \rightarrow Y \uparrow] \]
  
  \[ Y \uparrow \rightarrow \left( \frac{M^d}{P} \right) \text{ shifts up } \rightarrow i \uparrow \]
  
  \[ i \uparrow \rightarrow I(i) \rightarrow Y^{ad} \text{ shifts down somewhat, } \ldots \text{ and so on} \]

- In stead of this detailed market by market account of chain of events, use IS-LM

- Using the IS-LM
  
  - \( M^* \uparrow \rightarrow \text{ LM (and only LM) shifts right} \)
  
  - This takes into account all the changes in both the markets

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Fiscal Policy

- Looking at the individual markets
  
  \[ G \uparrow \rightarrow Y^{ad} \text{ shifts up } \rightarrow Y \uparrow \]
  
  \[ Y \uparrow \rightarrow \left( \frac{M^d}{P} \right) \text{ shifts up } \rightarrow i \uparrow \]
  
  \[ i \uparrow \rightarrow I(i) \rightarrow Y^{ad} \text{ shifts down somewhat, } \ldots \text{ and so on} \]

- In stead of this detailed market by market account of chain of events, use IS-LM

- Using the IS-LM
  
  - \( G \uparrow \rightarrow \text{ IS (and only IS) shifts right} \)
  
  - This takes into account all the changes in both the markets