Chapter 11 Aggregate Demand II

1 Explaining Fluctuations With the $IS-LM$ Model

1. $IS-LM$ model determines the interest rate and national income in the short run.

2. The $IS-LM$ model provides a theory to explain the position and slope of the aggregate demand curve.

1.1 Fiscal Policy

- Changes in government spending
  Why the horizontal shift in the IS curve is larger than the increase in equilibrium income?
  Answer: the crowding-out effect

- Changes in taxes

1.2 Monetary Policy

The monetary policy influences income by changing the interest rate (monetary transmission mechanism).

1.3 The Interaction Between Monetary and Fiscal Policy

1.4 Shocks in the $IS - LM$ Curve

- Shocks to the IS curve: investors' animal spirits, consumer confidence, and etc.

- Shocks to the LM curve: new restrictions on credit card, for example.

2 $IS - LM$ as a Theory of Aggregate Demand

Relax the assumption of a fixed price level

1. Use the $IS - LM$ model to derive the aggregate demand curve.

2. Examine what causes the aggregate demand curve to shift.

Summary:

- A change in income in the $IS - LM$ model resulting from a change in the price level represents a movement along the aggregate demand curve;

- A change in income in the $IS - LM$ model for a fixed price level represents a shift in the aggregate demand curve.

2.1 The $IS - LM$ Model in the Short Run and the Long Run

Think of the economy as described by three equations:

$$\begin{aligned} Y &= C(Y-T) + I(r) + G \qquad IS \\ M/P &= L(r, Y) \qquad\qquad\qquad\qquad LM \end{aligned}$$

The position and the slope of the aggregate demand curve is thus determined.

Three endogenous variables: Y, r, P

Now the third equation:

- The Keynesian approach: $P = P_1$
- The Classical approach: $Y = \overline{Y}$.