IS-LM Explanation

In IS-LM analysis, one figures out how the IS and LM curves have shifted, and the change in their intersection point is what happens.

It is essential to identify and to explain the shifts of the curves, as otherwise the theory is empty. For example, suppose one observes an increase in the national income and product, together with a rising interest rate. To say just that the IS curve must have shifted rightward is empty.

What is needed is to give some explanation of why the IS curve or the LM curve has shifted. Below some examples are listed.

LM Curve

That money supply equals money demand means

$$\frac{M}{P} = m^d\left(y.r\right).$$

An exogenous rise in P, fall in M, or increase in the function m^d will shift the LM curve up.

Price Level

An exogenous increase in the price level shifts the LM curve up:

- Oil price shocks of 1973 and 1979
- Currency devaluation (causing inflation)
- Wage explosion (France under Mitterand).

Nominal Money Supply

An exogenous decrease in the nominal money supply shifts the LM curve up.

In the Great Depression, the nominal money supply dropped by 1/3.

Money Demand

Keynesians see money demand as a stable relation between money, national income and product, and the interest rate.

However legislation in 1980 allowing banks to pay interest on checking deposits shifted the money demand up, causing the LM curve to shift up.

IS Curve

An exogenous increase in the aggregate demand for goods shifts the IS curve rightward.

The effect could be on consumption demand, investment demand, or government expenditure on goods and services.

Consumption Demand

Consumption demand would rise if:

- Decrease in income tax
- Decreased propensity to save
- Shift in income distribution toward people with high marginal propensity to consume.

Investment Demand

Investment demand would rise if:

- Investment tax credit
- Possible result of technical change
- Faster population growth
- Greater optimism about demand.

Government Expenditure

Government expenditure on goods and services would rise if:

- War
- Expansionary fiscal policy.