Classical Model

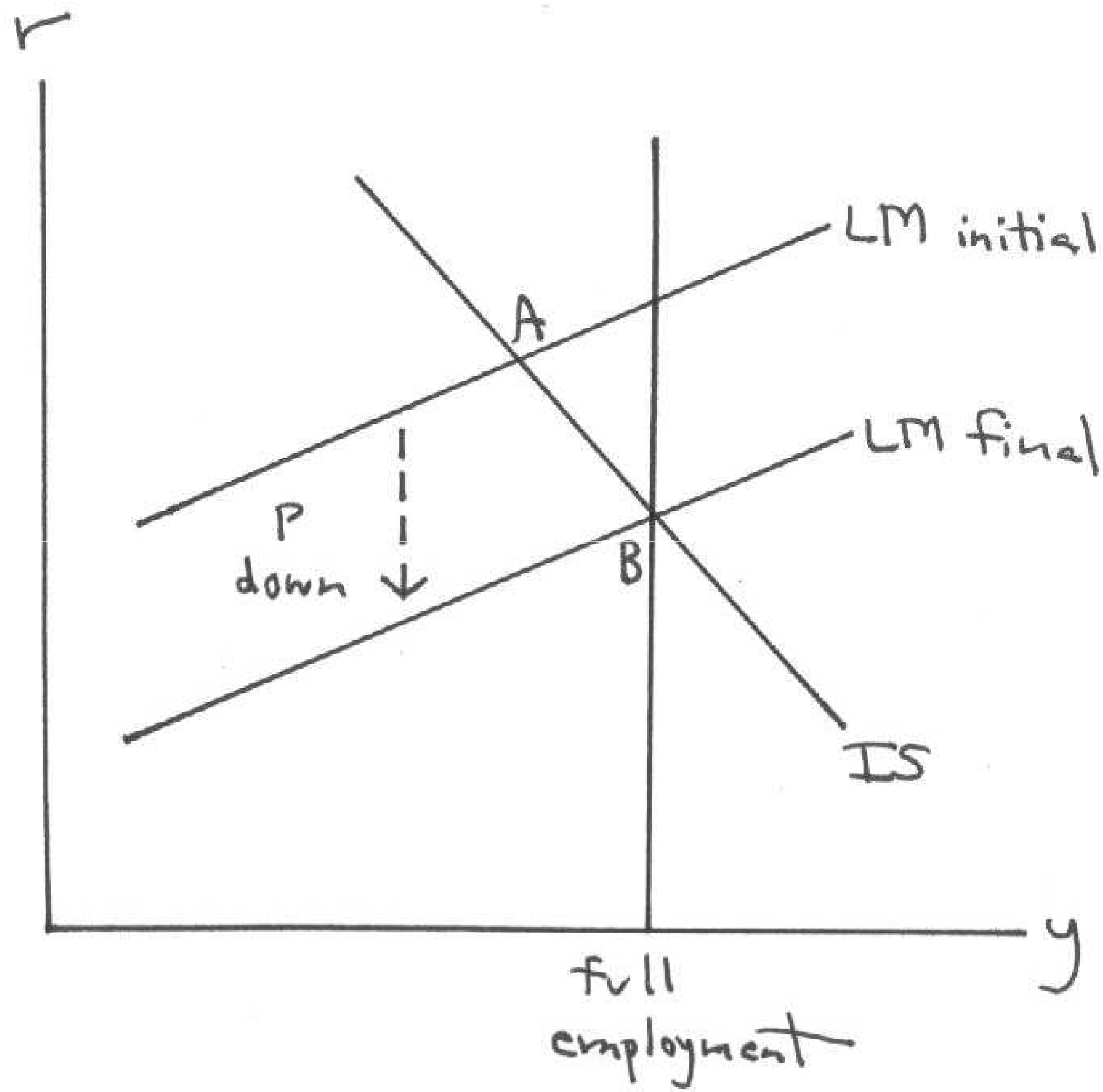
Even though the IS-LM model was developed to express Keynesian ideas, one can express the classical model via IS-LM.

Price Adjustment

In the classical model, the key is that price adjustment brings about equilibrium. Aggregate demand equals aggregate supply, and the economy is at full employment.

Consider an economy initially in recession (point A in figure 1). Unlike the Keynesian model, in the classical model the excess supply causes prices to fall.

Figure 1: Price Adjustment to Equilibrium



Reaction

The overall price level P falls, so the real money supply M/P rises. The LM curve falls, and the interest rate declines. The lower interest rate raises aggregate demand, and production rises in response to the higher demand. The economy moves *along* the IS curve.

This adjustment process continues until the economy arrives at full employment (point B in figure 1). Prices stop falling, as demand equals supply.

Neutrality of Money

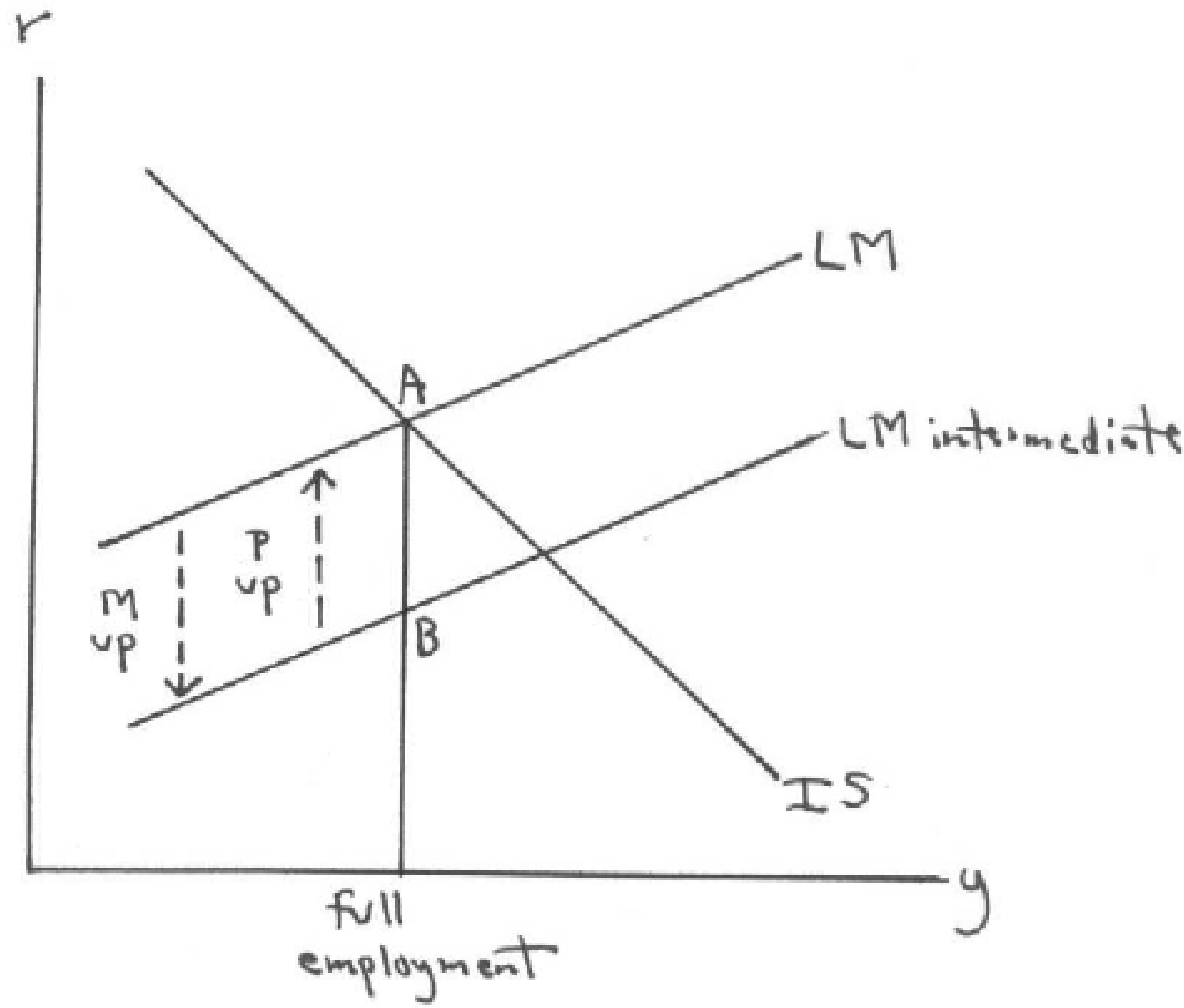
In the classical model, money is *neutral*. An increase in the money supply raises the overall price level by the same percentage, with no effect on real variables—real quantities and relative prices.

Price Adjustment

Consider the IS-LM model of an economy at full employment (point A in figure 2).

Let the money supply increase by 10%, so LM curve falls. The interest rate drops (point B). The lower interest rate raises the aggregate demand for goods, and the economy lies left of the IS curve.

Figure 2: Neutrality of Money



Demand exceeds product. Product cannot rise, as the economy is already at full employment. Hence the excess demand for goods causes prices to rise.

The price rise continues until prices have increased by 10%. As P rises, real money balances M/P fall. The LM curve shifts back up to its original position, and demand equals supply for goods (point A in figure 2).