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IS-LM Curve

Economics Notes For SEBI Grade A Exam

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The IS-LM curve, which stands for **"investment-savings" (IS) and "liquidity preference-money supply" (LM)** is a Keynesian macroeconomic model that shows how the market for economic goods (IS) interacts with the loanable funds market (LM) or money market.

It is **represented as a graph in which the IS and LM curves intersect to show the short-run equilibrium between interest rates and output.**

Key Takeaways

- The IS-LM curve describes how aggregate markets for real goods and financial markets interact to balance the rate of interest and total output in the macroeconomy.
- IS-LM stands for **"investment savings-liquidity preference-money supply"**.
- The curve was devised as a formal graphic representation of a principle of Keynesian economic theory.
- On the IS-LM graph, "IS" represents one curve while "LM" represents another curve.
- IS-LM can be used to describe how changes in market preferences alter the equilibrium levels of gross domestic product (GDP) and market interest rates.
- The IS-LM curve lacks the precision and realism to be a useful prescription tool for economic policy.

Breaking Down of IS-LM Curve

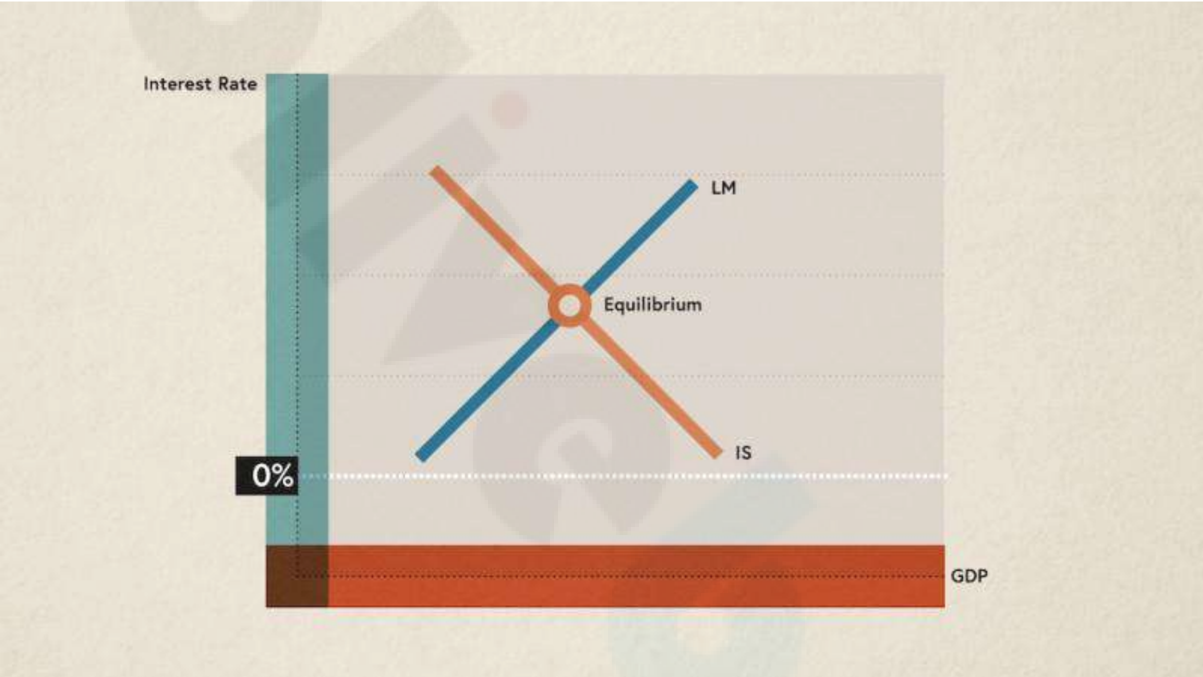
In order to gain a full understanding of how the four components work together, it is important to first understand what each component means on its own.

Investment: In macroeconomics, an investment is defined as a number of goods purchased in a period of time that is not consumed or used in that time. Investment increases as interest rates decrease.

Savings: Savings, sometimes known as deferred consumption, is income that is not spent. As interest rates fall, savings also fall, as most households take advantage of lower interest rates to make purchases.

Liquidity: Liquidity refers to the demand for and amount of real money, in all of its forms, in an economy. Those who part with liquidity, in the form of saving or investing, are rewarded through interest payments or dividends.

Money: Money is any verifiable record or item that can be used as a means of paying for goods and services.



Putting IS-LM Together

The IS curve describes the goods market.

The IS curve slopes down and to the right, representing the fact that as interest rates fall, people and businesses try to invest more in long-lasting goods like houses, cars, and equipment.

When interest rates fall, families also tend to put less away for savings and spend more on consumer goods.

Thus, the effect of a falling interest rate is an increase in GDP through greater investment and less personal savings.

The LM curve describes the money market.

The LM curve slopes up and to the right. It represents what economists call the money market.

As the economy expands, banks and other financial institutions need funds to support the extra investment.

To get those funds, they encourage consumers to deposit more of their cash into longer-term deposits like certificates of deposit or bonds.

The IS relationship and LM relationship create opposing forces.

On the one hand, a falling interest rate tends to cause the economy to expand. On the other hand, an expanding economy causes interest rates to rise.

Where the two curves meet, the forces are balanced, and the economy is in equilibrium.

How a Country's Central Bank Impacts IS-LM Curve?

A country's central bank can move the LM curve by printing money.

The more money the central bank prints, the less aggressively banks have to raise interest rates to attract deposits. This causes the LM curve to shift outward.

The lines will now cross at a new point—one where the interest rate is lower, and the economy is larger.

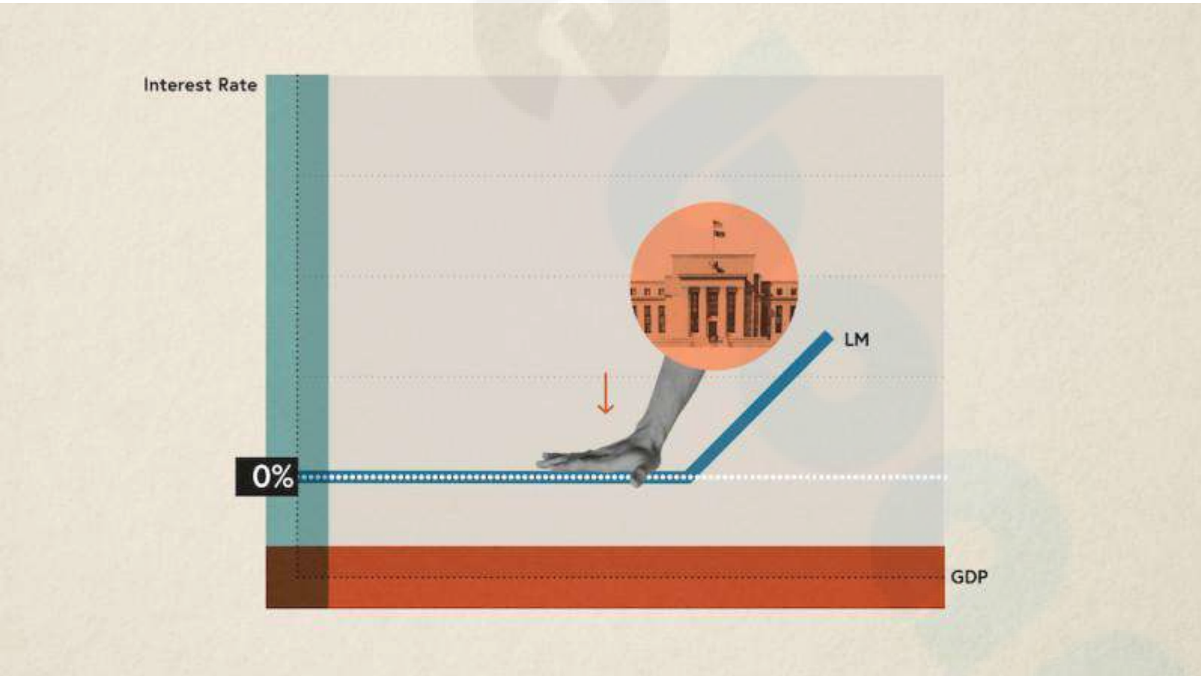
In this way, a central bank can control the GDP level.

Although the central bank can increase the strength of the economy by printing money, that comes at the cost of a higher rate of inflation.

Higher inflation causes the IS curve to shift inwards.

This causes interest rates to rise again and the economy to slow.

If the central bank is not careful, its actions can backfire and lead to an economy with high rates of inflation but not very high GDP growth.



Why the IS-LM Curve Is Flat at Zero?

Another tactic the central bank can use to increase the amount of money circulating in the economy is to lower interest rates.

Lower interest rates make it easier for households and businesses to borrow money from banks.

The loans that banks make inject more money into the economy and allow it to recover from the recession.

When interest rates hit zero, however, increases in the money supply have no effect.

Households and businesses no longer have an increased incentive to take out loans.

The extra money sits in banks without being spent.

This is the reason the LM curve is flat at zero.

Economists call the inability of interest rates to go below zero the zero lower bound.

The Pros and Cons of the IS-LM Model

The IS-LM model is a controversial economic tool. It has a number of detractors, including the creator Hicks himself, who said that the model is best used "as a classroom tool" rather than in any practical application. There are, however, pros to using the model.

Pros:

- The model is commonly used to explain Keynesian macroeconomics on a fundamental level.
- It is a good introduction to and the first approximation of policymaking.

Cons:

- Does not consider a huge variety of factors that come to play in the modern economy, such as international trade, demand, and capital flows.
- Takes a simplistic approach to fiscal policy, the money market, and money supply.
- Central banks today in most advanced economies prefer to control interest rates on the open market—for example, through sales of securities and bonds.
- This model cannot account for that and should not be used as the sole tool in determining monetary policy.
- It does not reveal anything about inflation or international trade and does not provide insight or recommendations for formulating tax rates and government spending.

- The IS-LM model is a great way to explain Keynes's ideas about how monetary systems, markets, and governmental actors can work together to drive economic growth.

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