JAYOTI VIDYAPEETH WOMEN'S UNIVERSITY, JAIPUR

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NAAC Accredited University

Faculty of Education and Methodology

Faculty Name- JV'n Dr. Md Meraj Alam

Program- BA (Hons) Economics 2nd Semester

Course – Macroeconomics II

Digital session name – Shift in the IS and LM curve

Shift in IS Curve:

It is important to understand what determines the position of the IS curve and what causes shifts in it. It is the level of autonomous expenditure which determines the position of the IS curve and changes in the autonomous expenditure cause a shift in it. By autonomous expenditure we mean the expenditure, be it investment expenditure, the Government spending or consumption expenditure which does not depend on the level of income and the rate of interest.

The government expenditure is an important type of autonomous expenditure. Note that the Government expenditure which is determined by several factors as well as by the policies of the Government does not depend on the level of income and the rate of interest.

Similarly, some consumption expenditure has to be made if individuals have to survive even by borrowing from others or by spending their savings made in the past year. Such consumption expenditure is a sort of autonomous expenditure and changes in it do not depend on the changes in income and rate of interest. Further, autonomous changes in investment can also occur.

In the goods market equilibrium of the simple Keynesian model the investment expenditure is treated as autonomous or independent of the level of income and therefore does not vary as the level of income increases. However, in the complete Keynesian model, the investment spending is thought to be determined by the rate of interest along with marginal efficiency of investment.

Following this complete Keynesian model, in the derivation of the IS curve we consider the level of investment and changes in it as determined by the rate of interest along with marginal efficiency of capital. However, there can be changes in investment spending autonomous or independent of the changes in rate of interest and the level of income.

For instance, growing population requires more investment in house construction, school buildings, roads, etc., which does not depend on changes in level of income or rate of interest. Further, autonomous changes in investment spending can also take place when new innovations come about, that is, when there is progress in technology and new machines, equipment, tools etc., have to be built embodying the new technology.

Besides, Government expenditure is also of autonomous type as it does not depend on income and rate of interest in the economy. As is well- known government increases its expenditure for the purpose of promoting social welfare and accelerating economic growth. Increase in Government expenditure will cause a rightward shift in the IS curve.

Shifts in the LM Curve:

Another important thing to know about the IS-LM curve model is that what brings about shifts in the LM curve or, in other words, what determines the position of the LM curve. As seen above, a LM curve is drawn by keeping the stock or money supply fixed.

Therefore, when the money supply increases, given the money demand function, it will lower the rate of interest at the given level of income. This is because with income fixed, the rate of interest must fall so that demands for money for speculative and transactions motive rises to become equal to the greater money supply. This will cause the LM curve to shift outward to the right.

The other factor which causes a shift in the LM curve is the change in liquidity preference (money demand function) for a given level of income. If the liquidity preference function for a given level of income shifts upward, this, given the stock of money, will lead to the rise in the rate of interest for a given level of income. This will bring about a shift in the LM curve to the left.

It therefore follows from above that increase in the money demand function causes the LM curve to shift to the left. Similarly, on the contrary, if the money demand function for a given level of income declines, it will lower the rate of interest for a given level of income and will therefore shift the LM curve to the right.

The LM Curve: The Essential Features:

From our analysis of the LM curve, we arrive at its following essential features:

1. The LM curve is a schedule that describes the combinations of rate of interest and level of income at which money market is in equilibrium.

2. The LM curve slopes upward to the right.

3. The LM curve is flatter if the interest elasticity of demand for money is high. On the contrary, the LM curve is steep if the interest elasticity demand for money is low.

4. The LM curve shifts to the right when the stock of money supply is increased and it shifts to the left if the stock of money supply is reduced.

5. The LM curve shifts to the left if there is an increase in the money demand function which raises the quantity of money demanded at the given interest rate and income level. On the other hand, the LM curve shifts to the right if there is a decrease in the money demand function which lowers the amount of money demanded at given levels of interest rate and income.

Course Outcome: The goal of this paper will be to expose the students to the basic principles of macroeconomics. The emphasis will be on thinking like an economist and course will illustrate how economic concepts can be applied to analyse real-life situations. In this course, the students are introduced to money and interest, theories of inflation, rate of interest, trade cycle and growth models.