

LM: money market

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Assume fixed supply of real money balances

$$\left(\frac{M}{P}\right)^s = \frac{\bar{M}}{\bar{P}}$$

Note: P fixed because this is short-run

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LM: money market

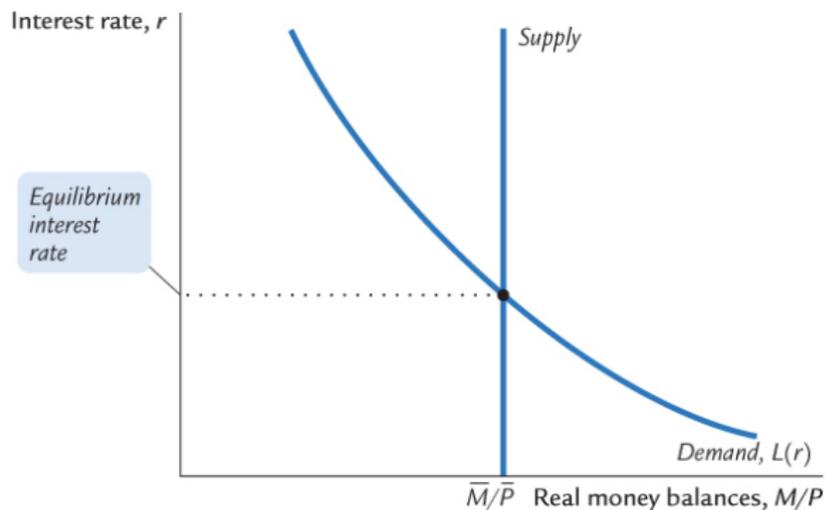
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$$\left(\frac{M}{P}\right)^d = L(r)$$

LM: money market

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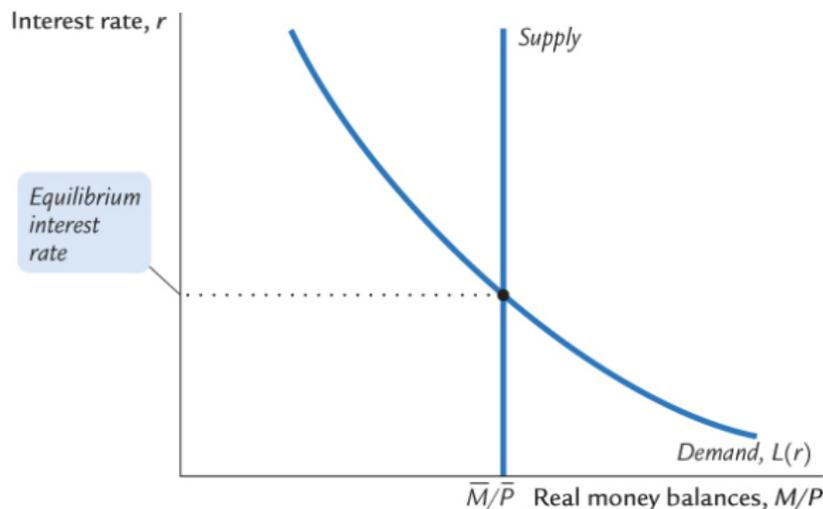
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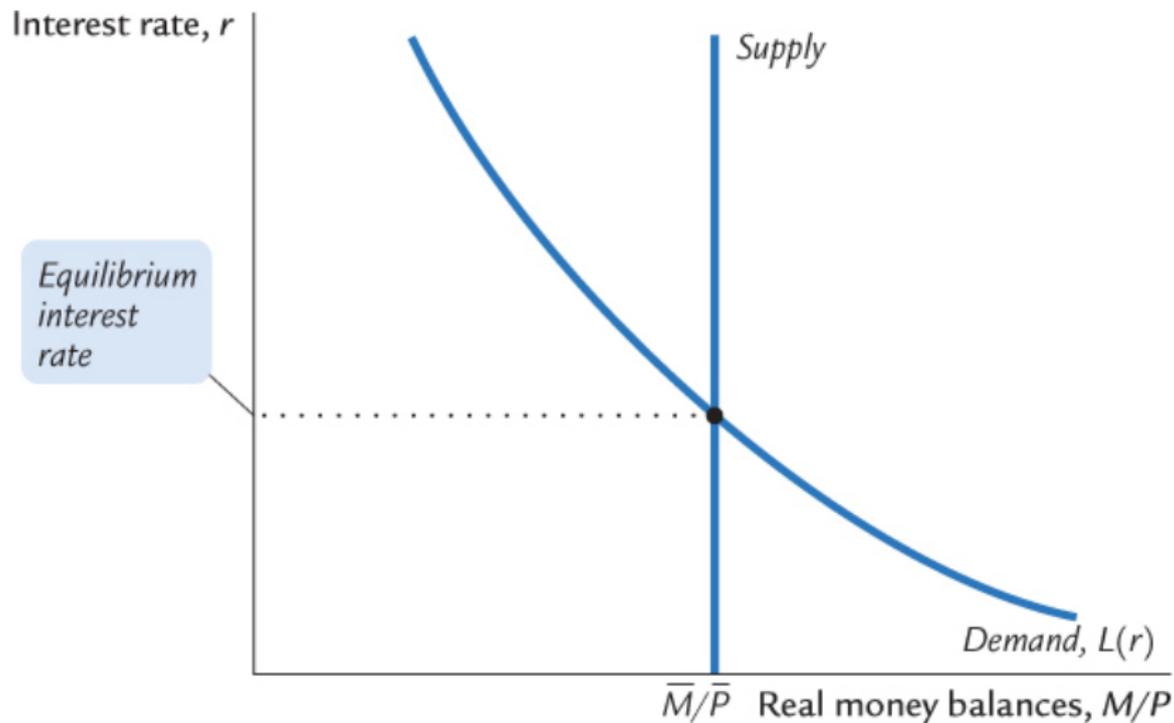
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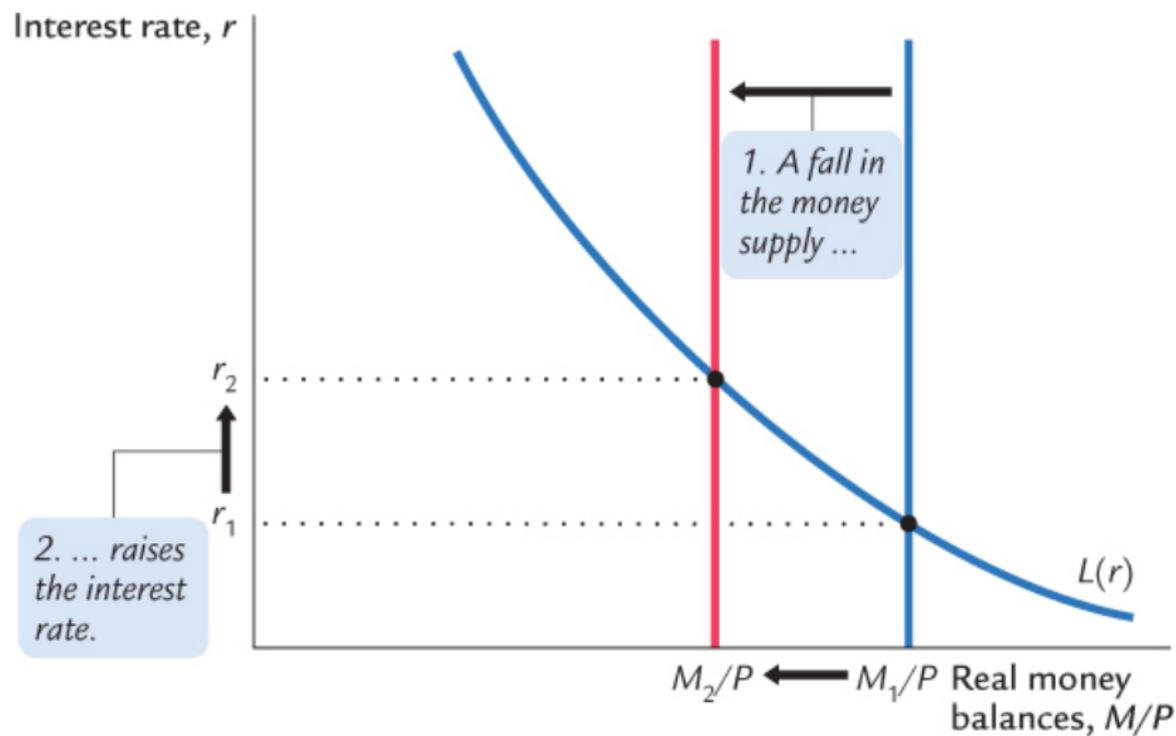


How do we get to equilibrium?

How does $\downarrow M$ affect the money market?



How does $\downarrow M$ affect the money market?



LM curve

Need to include Y :

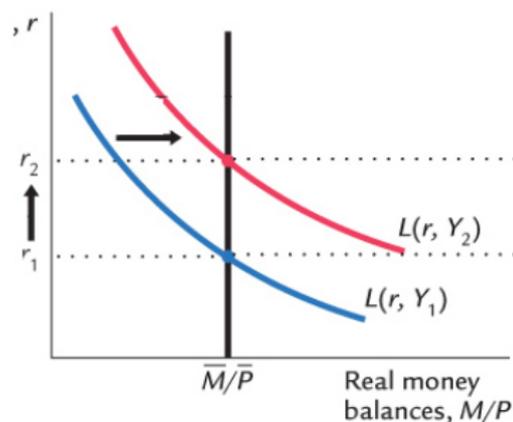
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LM curve

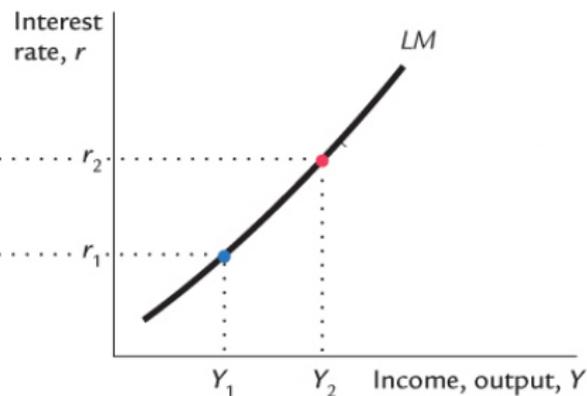
Need to include Y :

$$\left(\frac{M}{P}\right)^d = L(r, Y)$$

(a) The Market for Real Money Balances



(b) The LM Curve

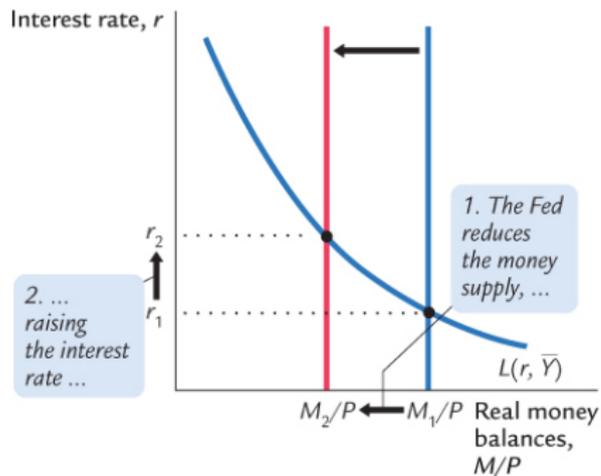


LM practice

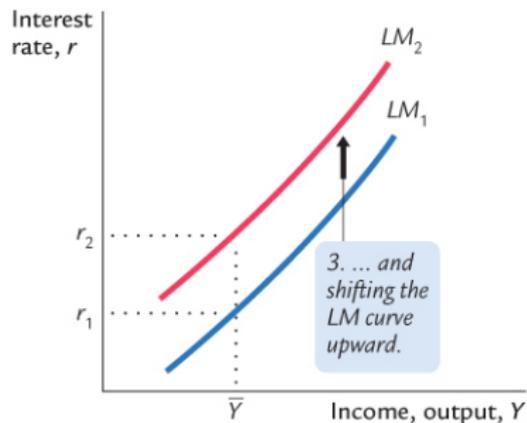
In groups: show how an increase in M will shift the LM curve

LM practice

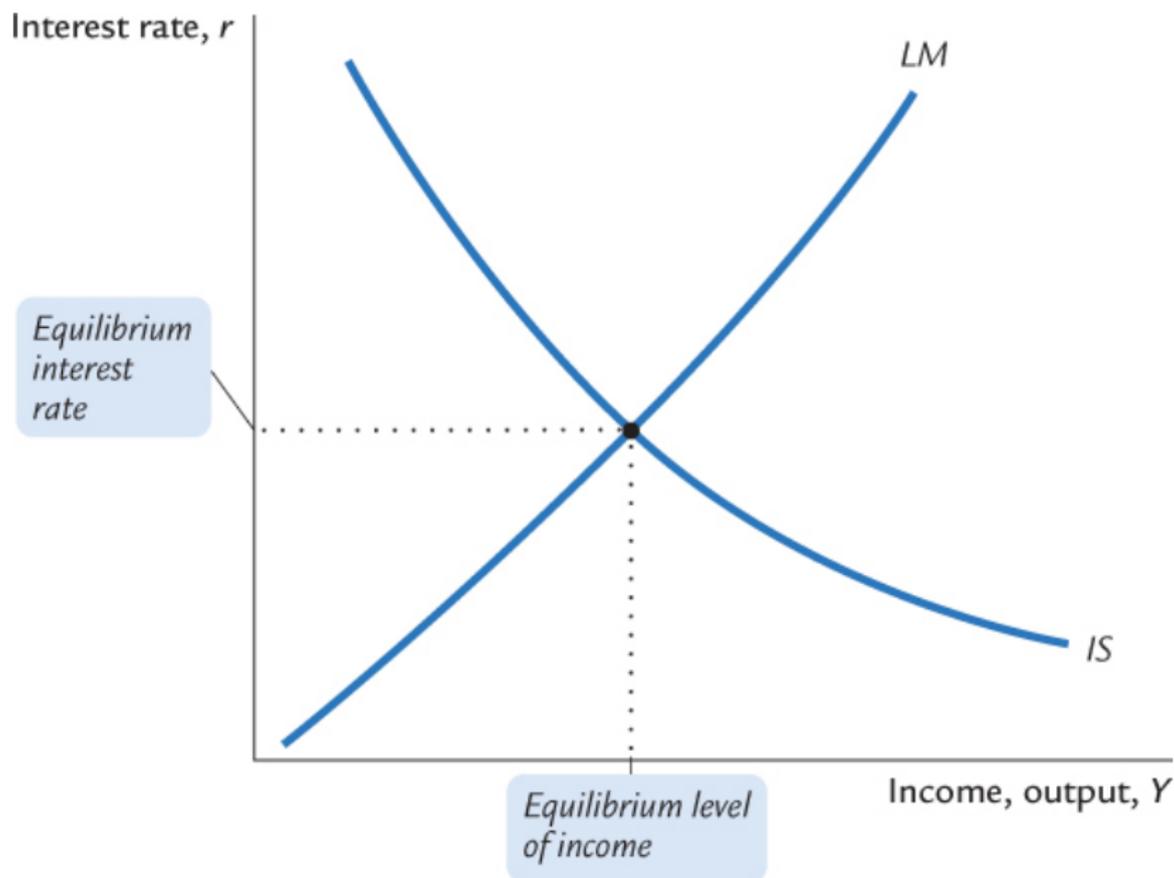
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(b) The LM Curve



IS-LM equilibrium



IS-LM practice

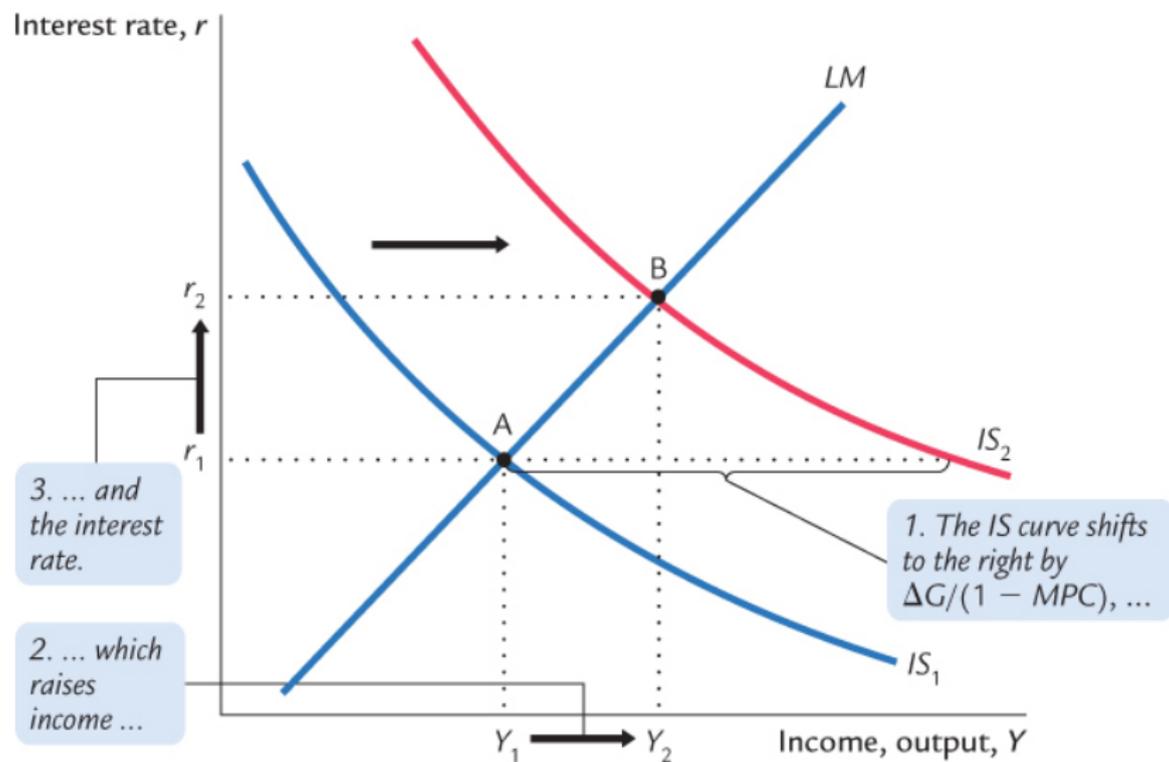
Work through:

1. effect of an increase in G
2. effect of new tech that increases MPK
3. effect of an increase in M
4. effect of an increase in P
5. effect of an increase in T

“Animal spirits”?

How could the US government or the Fed respond to these events?

IS-LM: effect of G



Interest rate and money supply targets

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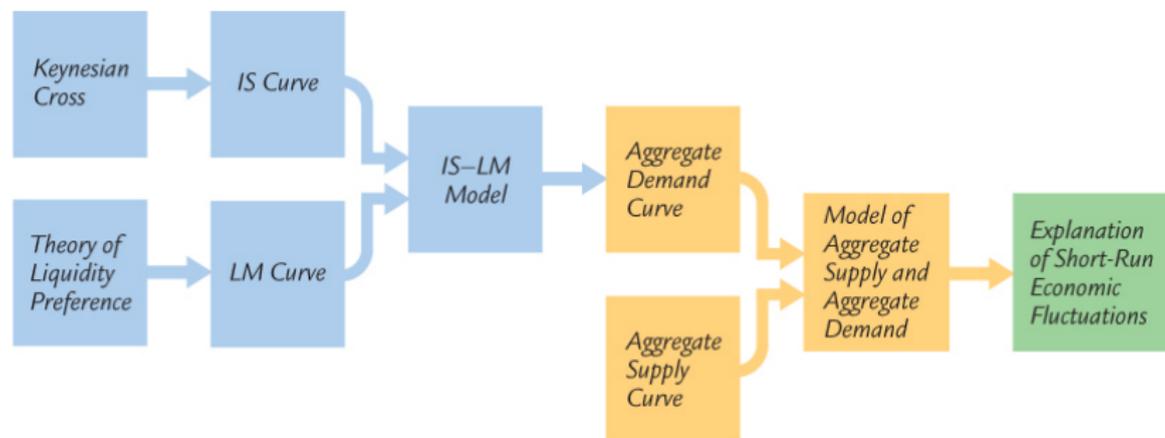
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If LM curve shocks more common than IS curve shocks, targeting r produces more stability

The big picture



IS-LM model created by John Hicks in 1937