Model 3
IS-LM MODEL

Goods and Asset Markets Only

<u>Goods Market</u> (Model applies only when Y < Y*)

1.   Consumption $C = a + b*Yd$ $1 > b > 0$

2.   Disposable Income $Yd = Y - T$

3.   Income Taxes $T = t0 + t1*Y$ $0 < t1 < 1$

4.   Investment Demand $I = e - d*r$ $d > 0$

5.   Net Export Demand $X = g - m*Y - n*r$ $m,n > 0$

6.   Planned Expenditures $AD = C + I + G + X$

7.   Goods Market Equilibrium $Y = AD$

Equations 1 - 7 can be used to derive an IS Curve.

$$Y = \frac{a - b*t0 + e - (d+n)*r + g + G}{1 - b*(1 - t1) + m}$$

with slope $\dfrac{\Delta r}{\Delta Y} = - \dfrac{1 - b*(1-t1) + m}{d + n}$

<u>Asset Market</u>

8.   Portfolio Balance $\dfrac{Md}{P} = k*Y - h*r$ $k,h > 0$

9.   Money Market Equilibrium $M = Md$

Equations 8 and 9 are used to derive an LM curve

$r = (k/h)*Y - (1/h)*(M/P)$ which has slope $\dfrac{\Delta r}{\Delta Y} = \dfrac{k}{h}$

<u>Endogenous Variables</u>   <u>Exogenous Variables</u>
C,Yd,Y,T,I,r,X,AD,Md   a,t0,t1,e,g,G,P,M