The *IS/LM* Model

Based on Blanchard, 7th edition, chapters 3-6

The *IS/LM* Model (version 1, chapters 3-5)

- *IS:* the elements in the construction of *IS* are *C, I, G,* and *NX*, and all the factors that influence these four variables.

$C = f(Y_D, \text{real wealth, expectations, credit market conditions, ...})$
$I = g(i, \text{expectations, credit market conditions, ...})$
$G = \bar{G}$
$NX = \overline{NX}$
$T = \text{taxes, net of transfers, given}$

- *LM:* the elements in the construction of *LM* are demand for money, supply of money, and all factors that influence these two variables.

$M^d = \bar{P}Y \cdot L(i)$
$\dfrac{M^s}{P} = \dfrac{\bar{M}}{\bar{P}}$

- Interest-rate targeting: horizontal *LM* curve.

The *IS/LM* Model (version 2; with risk premia and nominal vs. real interest rates, chapter 6)

Fisher Equation

$$r_t = i_t - \pi^e_{t+1} \iff i_t = r_t + \pi^e_{t+1}.$$

- *IS* relation: $Y = C(Y - T) + I(Y, i - \pi^e + x) + G + NX.$ x is the risk premium.

- *LM* relation: $i = \bar{i}.$

However, "although the central bank formally chooses the nominal interest rate, it can choose it in such a way as to achieve the real interest rate it wants". This ignores the issue of zero lower bound—to be discussed.