The IS/LM Model

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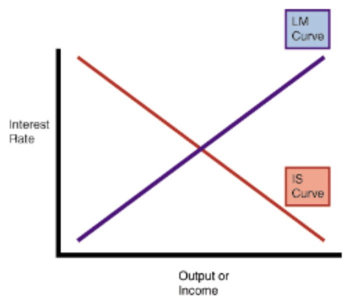
IS - LM model



IS and LM curves

IS CURVE :
-G & S Market
- Investment = Savings
- Y=C(Y-T(Y))+I(r)+G+NX(Y)

LM CURVE:
-Money Market
-Liquidity Preference
-Transactional and Speculative Demand

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IS-LM model in open economy

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IS CURVE
LM CURVE
BP CURVE

BP Curve

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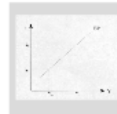

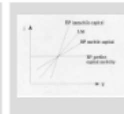

EXCHANGE RATE

The price of a nation's currency in terms of another currency. An exchange rate thus has two components, the domestic currency and a foreign currency.

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Fixed Exchange Rate

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A country's exchange rate regime under which the government or central bank ties the official exchange rate to another country's currency (or the price of gold). The purpose of a fixed exchange rate system is to maintain a country's currency value within a very narrow band.

A fixed exchange rate is usually used to stabilize the value of a currency against the currency it is pegged to.
This makes trade and investments between the two currency areas easier and more predictable, and is especially useful for small economies in which external trade forms a large part of their GDP.

Floating Exchange Rate

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A country's exchange rate regime where its currency is set by the foreign-exchange market through supply and demand for that particular currency relative to other currencies.

In the modern world, most of the world's currencies are floating; such currencies include the most widely traded currencies: the United States dollar, the euro, the Norwegian krone, the Japanese yen, the British pound, and the Australian dollar.

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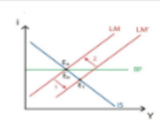
1.Fixed exchange rate (monetary policy and fiscal policy)

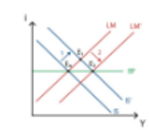
If expansionary monetary policy shift the LM curve to LM', it will lead the equilibrium to go from point E0 to E1

And if exchange rates are fixed, government intervention is needed, which will decrease the money supply and shift the LM' curve back to its original position



Expansionary fiscal policy is policy that shift the IS curve to IS', which will move equilibrium form point E0 to point E1

There will be opposite intervention of government, which will increase the money supply and shift the LM curve to the right.

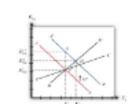


2. Floating exchange rate (monetary policy and fiscal policy)

Suppose the economy is originally at a super equilibrium shown as point F.

The original GNP level is Y1 and the exchange rate is E$/£

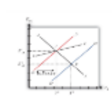
Money supply changes cause a shift in the AA curve. More specifically, an increase in the money supply will cause AA to shift upward



Suppose the economy is originally at a super equilibrium shown as point J .

The original gross national product (GNP) level is Y and the exchange rate is E$/£

Fiscal policy changes cause a shift in the DD curve. More specifically, an increase in government spending (or an increase in transfer payments or a decrease in taxes) will cause DD to shift rightward



IS-LM Model in Open Economy

Nejra Rasa
Belma Bojcic
Mirza Bisher
Guven Colakovic

13. august 2014. godine Sarajevo
International Economics
School of Economics and Business in Sarajevo

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IS-LM model in open economy

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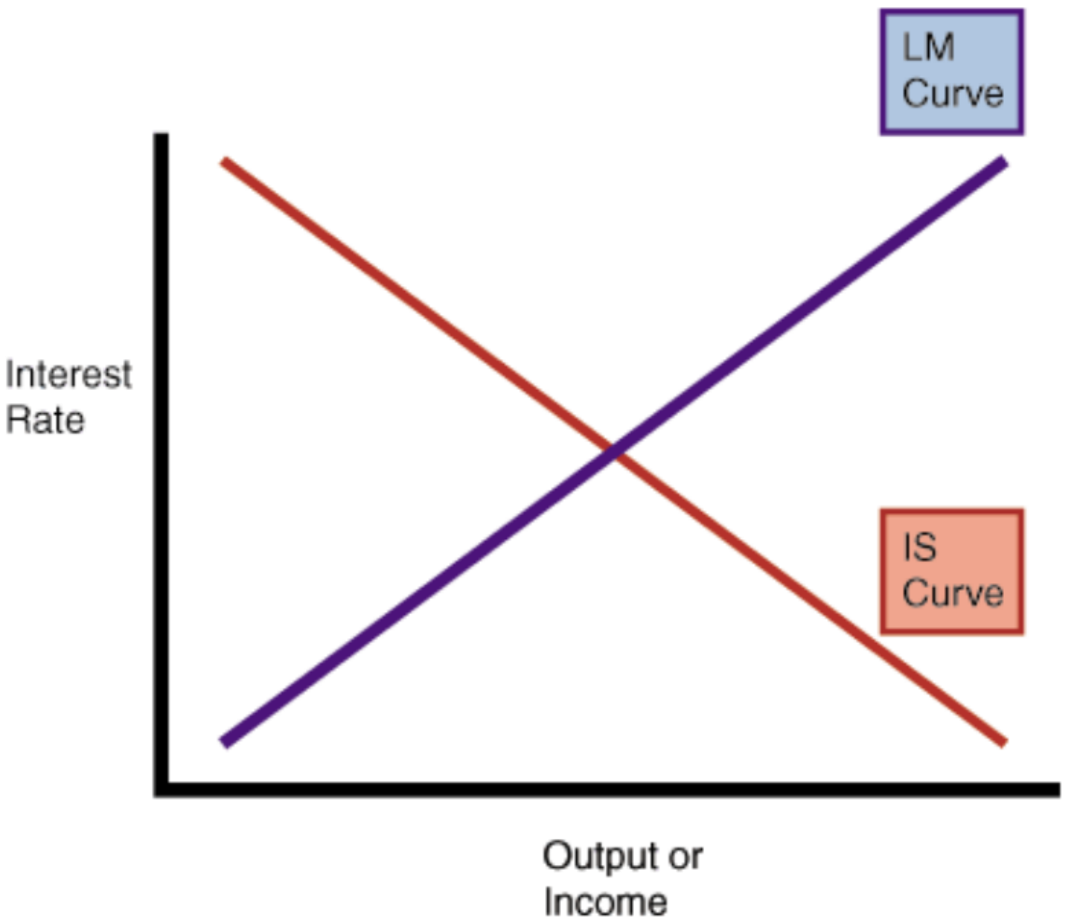
IS CURVE
LM CURVE
BP CURVE

IS - LM model



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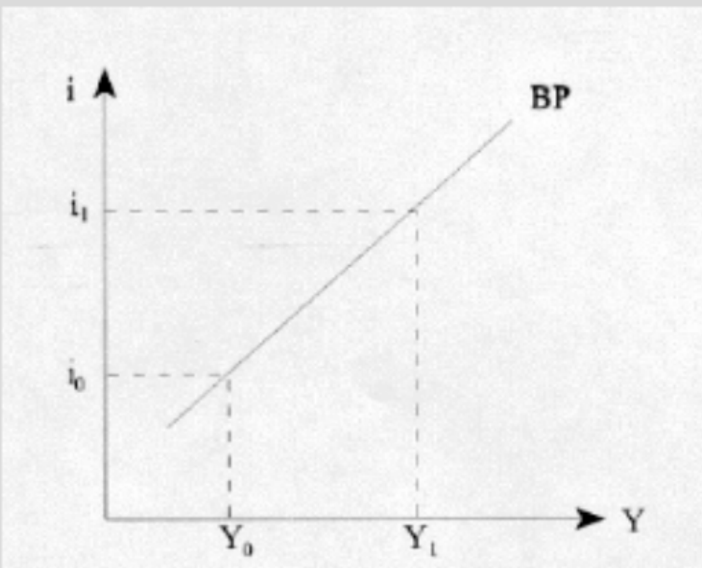

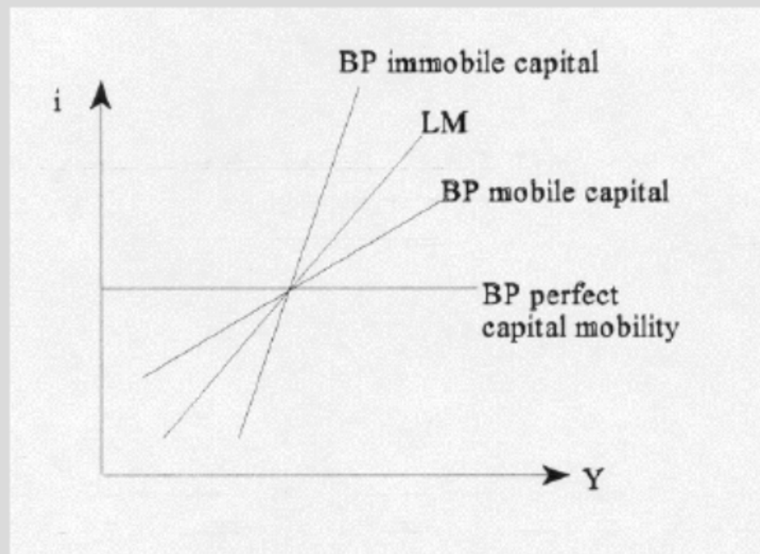

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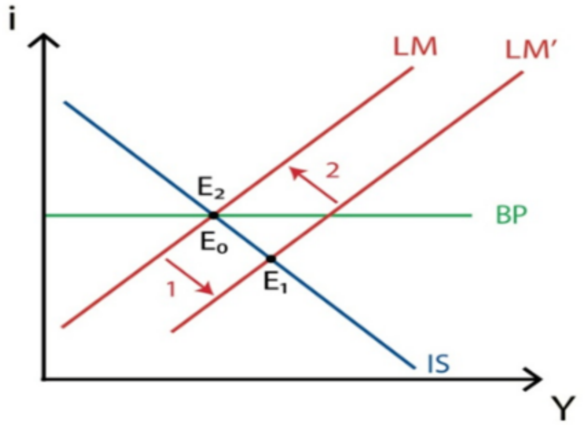

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