LM model – Money market

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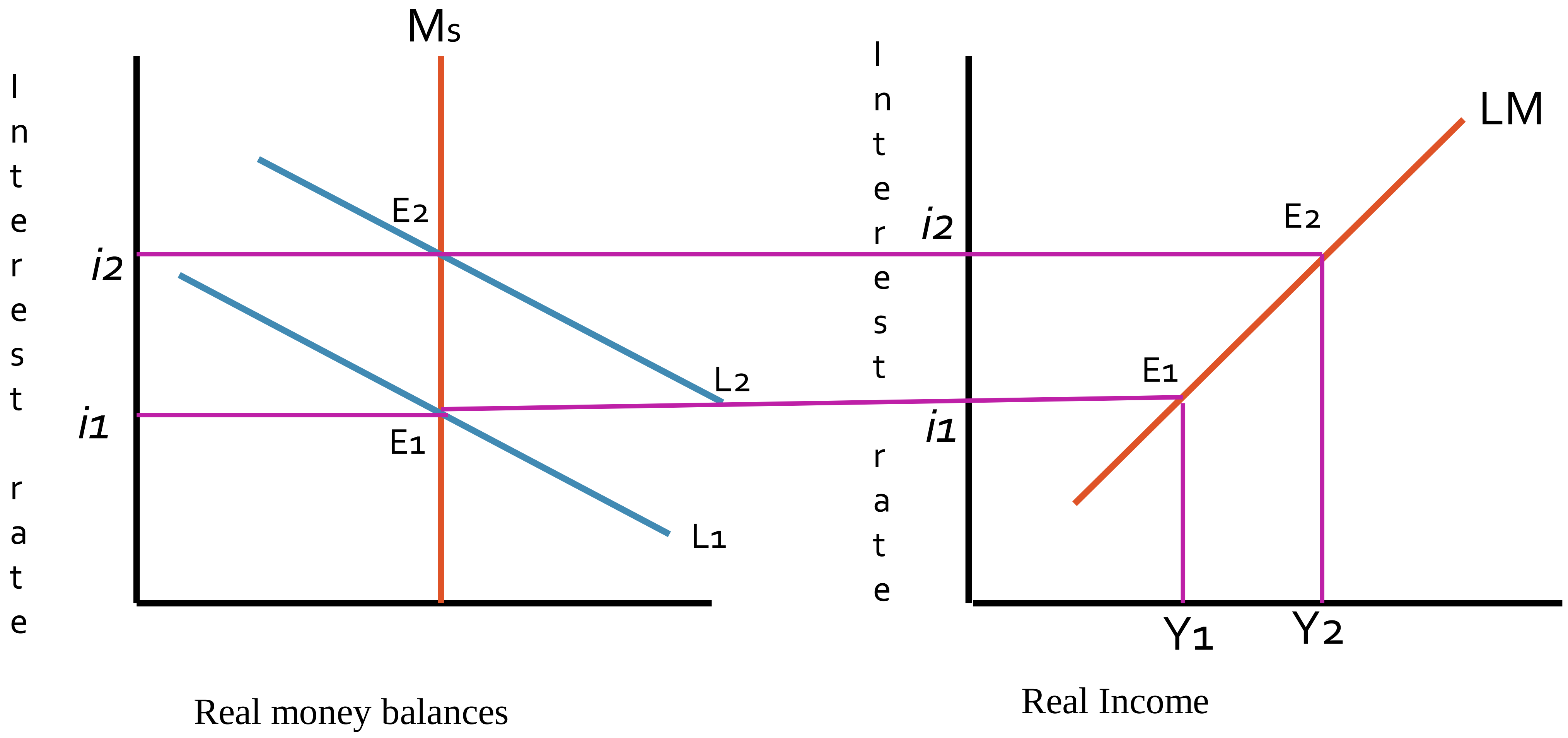
LM MODEL – THE MONEY MARKET AND LM CURVE

- Money market is concerned with demand for and supply of money
- When Md = Ms the money market is in equilibrium
- The LM curve depicts different combinations of interest rates and income at which the market is in equilibrium
- LM curve represents the point wherein liquidity preference (L) is equal to Ms.

THE LM CURVE



Ms
Interest rate
i2
i1
E2
E1
L2
L1
Real money balances
Interest rate
i2
i1
LM
E2
E1
Y1
Y2
Real Income

DERIVATION OF THE LM CURVE

- PANEL A
- Ms is a perfectly inelastic money supply line controlled by RBI
- Demand for money is the demand for real balances (L1 and L2)
- Demand for real balances depends on

1. Real income
2. Interest rate

- As the income increases demand curve for money will shift to the right
- Demand for money is inversely related to r/i

- PANEL B
- There is equilibrium at E1 with Y1 levels of income and *i1* interest rate
- When income rises to Y2, demand for money shifts to L2,
- For the demand for money and supply of money needs to balance
- That is why interest rate rises to *i2*
- Economy settles at E2
- E1 and E2 when connected we get upward sloping LM curve

Slope of the LM Curve

- The LM curve slopes upward
- It has a positive slope
- Increase in interest rate reduces the demand for money
- For Md = Ms the income levels have to rise
- Hence increase in the rate of interest is accompanied by increase in income
- If the demand for money is less responsive to interest rates the steeper is the LM curve
- if demand for money is relatively insensitive to interest rate, LM curve is vertical
- If demand for money very sensitive to interest rate, LM curve is almost horizontal

SHIFTS IN LM CURVE