The standard (Keynesian) model of a closed economy is the IS-LM model. In a closed economy, there is no ex. rate or fx market, so the analysis is in terms of (R, Y).

\[ R \quad \text{LM - asset mkt. equil.} \]

\[ Y \quad \text{IS - goods mkt. equil.} \]

\[ R \uparrow \Rightarrow \text{Investment } \downarrow \Rightarrow Y \downarrow \]

\[ Y \uparrow \Rightarrow M^d \uparrow \Rightarrow R \uparrow \text{ (to bring } M^d \text{ back down) } \]

\[ \{ \text{IS slopes down} \]

\[ \{ \text{LM slopes up} \]

2 Main Differences Between DD-AA and IS-LM

1. IS-LM explicitly assumes R affects spending

2. DD-AA explicitly incorporates expectations.
How does $R$ affect DD curve?

$Y = D(\frac{E^*_P}{P}, Y^*, R)$

But from UIP, $R = R^* + \frac{E^* - E}{E}$. Substitute,

$Y = D(\frac{E^*_P}{P}, Y^*, E, E^*, R^*)$

For given values of $(E^*, R^*)$, $E$ still affects aggregate demand positively (this time by lowering interest rates).

Expansionary Monetary Policy still increases output. Not only does it increase $NX$ (by making domestic goods more competitive), but it also increases investment (by lowering interest rates).
Expansionary Fiscal Policy

Now expansionary fiscal policy crowds out investment as well as NX.