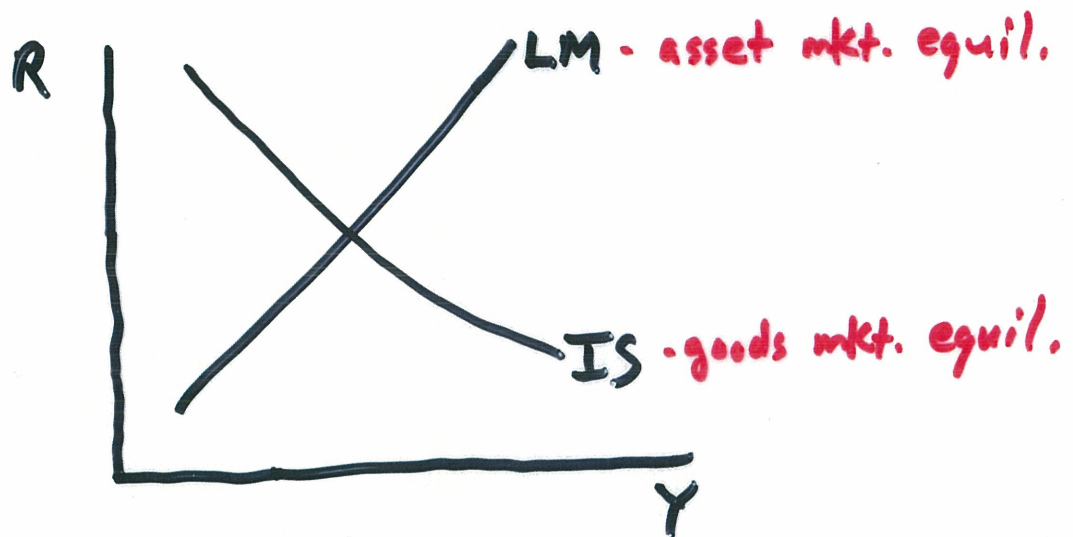


DD-AA vs. IS-LM

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) .



$R \uparrow \Rightarrow \text{Investment} \downarrow \Rightarrow Y \downarrow$

} IS slopes down

$Y \uparrow \Rightarrow M^d \uparrow \Rightarrow R \uparrow$ (to bring M^d back down)

} 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.

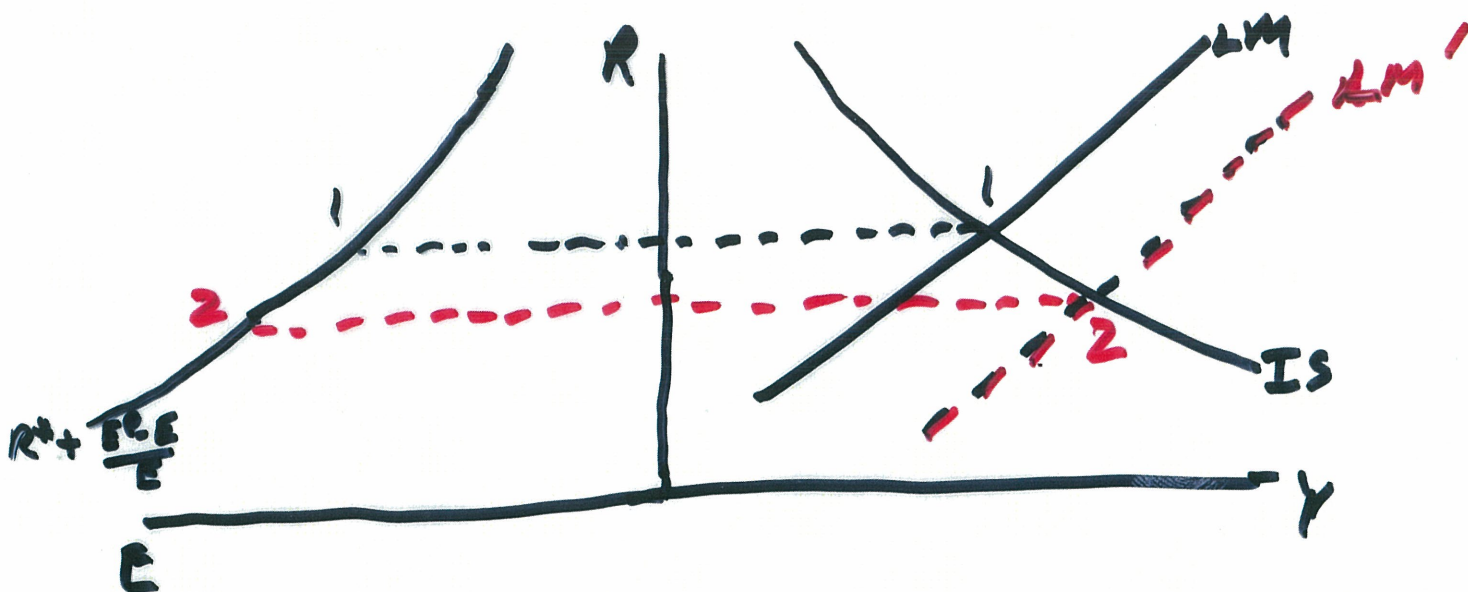
How does R affect DD curve?

$$Y = D\left(\frac{E^+ P^+}{P}, Y^d, \bar{R}\right)$$

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

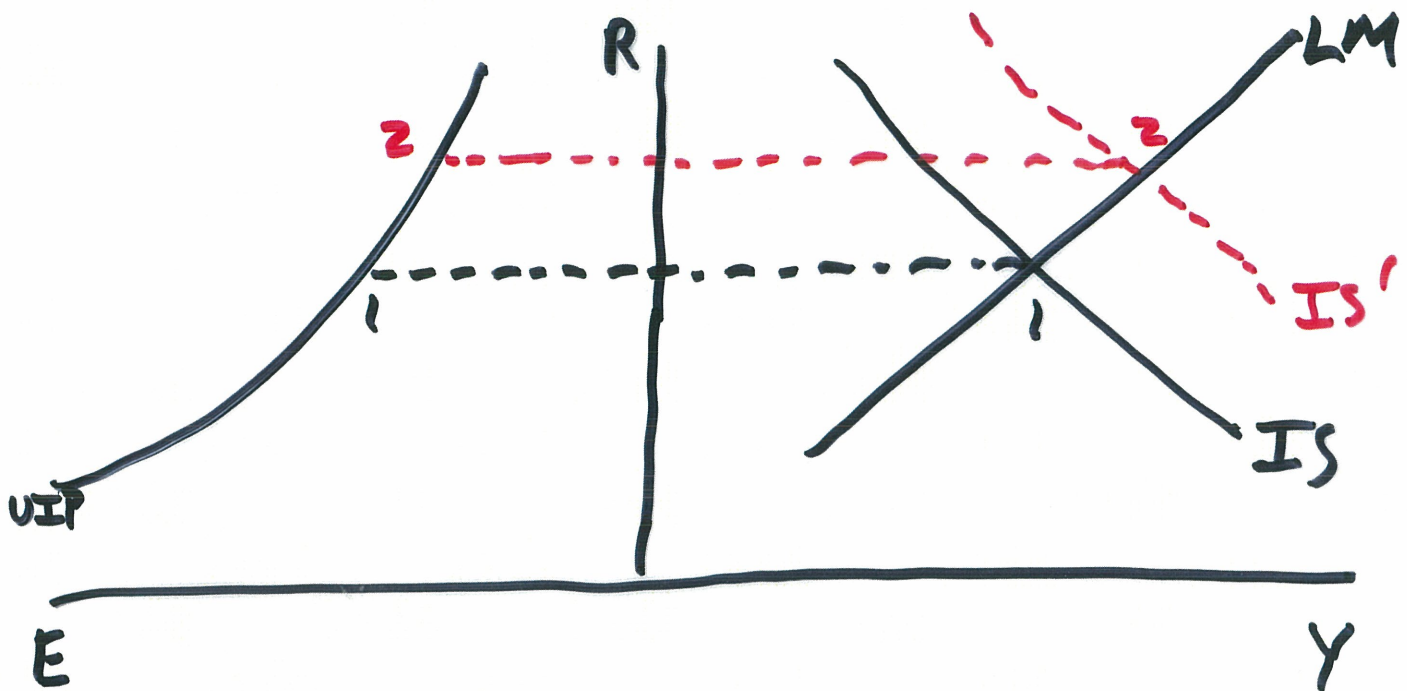
$$Y = D\left(\frac{E^+ P^+}{P}, Y^d, E, E^e, R^*\right)$$

For given values of (E^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 .