

Position of fe line and is curve analysis



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The employees choose to work when the organizations offer high wages to them and on the other hand organizations have a preference to hire employees while the wage rate is low, the labor market equilibrium is to balance out the contradictory needs of employees and organizations and find out the wage rate and the employment examined in the labor market. The labor market equilibrium find out an amount of labor, and that amount of labor through the production function determines full employment level of output. As the level of output does not rely on the rate of interest the full employment line would be plotted as a vertical line in the graph.

The first example of change in economy that would shift the FE line to right is the increase in labor supply, when the labor population increases the equilibrium employment also increases which in turn increases the full employment output and shifts the FE line to right. The second example of the change in economy is the increase in capital stock when the capital stock increases the additional output can be produced with the same number of labor and that would shift the FE line to right.

Q2) What relationship does the IS curve capture? Derive the IS curve graphically and show why it slopes as it does. Give Two examples of changes in the economy that would cause the IS curve to shift down and to the left.

The IS curve illustrates the correlation between the real interest rate and income for which investment is equals to savings. The graphical representation is based on the dependent variable which shows the income level and the independent variable which is rate of interest. The IS curve is drawn as down-ward sloping with the rate of interest (r) on vertical axes and

the level of income (Y) on horizontal axis. Is curve represents the equilibrium point where total investment equals to total savings.

Derivation of IS curve

The saving curvature incline upward as the high rate of interest increases savings whereas an increase in income shifts the saving curvature to the right, because people save more when their income is more and the investment curvature slopes downward as the high rate of interest decreases the preferred capital stock which in turn decreases investment. At the higher level of income the saving curvature shifts to the right comparatively when level of income is low. The interest rate is lower at the increased level of income due to which the IS curvature slopes downward.

The first example of the change in economy that would cause the IS curve to shift down and to left is due to taxes when consumer without considering future tax cut decreases the consumption it increases the savings and decreases the rate of interest that clears the good market. The second example of the change in economy is when due to the effective tax rate on capital investment decreases which also decreases the rate of interest and shifts the IS curve down and to the left.

Q3) What relationship does the LM curve capture? Derive the LM curve graphically and show why it slopes as it does. Give two examples of changes in the economy that would causes the LM curve to shift down and to the right.

The LM curve illustrates the relationship between rate of interest and income for which the asset market is in equilibrium. Like the graphical representation of IS the LM s graph also has two variables; the independent variable is income and the dependent variable is rate of interest. The LM curvature is upward sloping and characterizes the amount of money demanded which is equal to the amount of money supplied.

Derivation of LM curve

The LM curvature can be derive by projecting demand of money for different levels of income and the resulting equilibrium. If we talk about equilibrium it says that when income rises the demand for money increases and when the demand for money increase it makes people to sell their fixed assets so the cost of those assets decreases and the rate of interest increases. As the rate of interest increases the money demand decreases till the equilibrium is achieved and due to this the LM curvature slopes upward from left to right.

The first example of the change in economy that would cause the LM curve to shift down and to the right is due to increase in nominal money supply, when money supply increases, it decrease the rate of interest and achieve the point of equilibrium where money supplied equals money demanded.

The other example of the change in economy is when there is increase in expected inflation the money demand increases as well as the rate of interest increases and achieve the equilibrium that causes the LM curve to shift down and to the right.

Q5) Define general equilibrium and show the general equilibrium point in the IS-LM diagram. If the economy isn t in general equilibrium, what determines

output and the real interest rate? What economic forces act to bring the economy back to general equilibrium?

The general equilibrium is when FE line, IS curvature and the LM curvature intersects. It is indicated that outside variations are quite sensitive to the perseverance of interest rate and the output. The economic forces such as price adjustments in IS-LM model in terms of increase in government purchases and real money supply will work to bring back the economy back to general equilibrium.

Q7) What two variables are related by the aggregate demand (AD) curve? Why does the AD curve slope downward? Give two examples of changes in the economy that shift the AD curve up and to the right and explain why the shifts occur.

The two variables that are related to aggregate demand are price and income. The AD curve slopes downward because the AD curve considers the IS-LM illustration in which the LM curvature is drawn for fixed level of prices if price changes then LM curvature also shifts. At different levels of prices the IS-LM junctions determines the income level with various prices. The income and price on the graph gives the aggregate demand.

For example any variable like the rate of interest or income except price that moves IS or LM from their original position it would also shift aggregate demand, the way of movement is determined by identifying the change in IS-LM model like if there is an increase in income level it shows the movement in IS-LM graph. Therefore IS and LM meet at higher income level, then the aggregate demand curvature moves to the right.

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