Quadrant II - Notes

Paper Code: ECC 104

Module Name: Shifts in LM curve

Module No: 04

❖ Concept of LM curve

- **LM curve shows the combinations of interest rates and levels of real income for which the money market is in equilibrium.**
- **This means money demand is exactly equal to money supply.**
- **The LM curve slopes upward to the right. This is because with higher levels of income, demand curve for money (M^d) is higher and consequently the money- market is in equilibrium.**

❖ Why LM curve shifts

❒ **Shifts in the LM curve**

As we know LM curve has been derived from the Keynesian theory of money market equilibrium. So, one of the important areas in which we need to focuse on is the shifts in LM curve.

situations under which LM curve shifts

1. **changes in money supply how it leads LM curve to shift.**
2. **changes in demand for money how it leads LM curve to shift.**

1.changes in money supply how it leads LM curve to shift.

a) LM curve shifts to right

Increase in money supply leads to more money circulation in the economy so during this point of time demand for money in the economy is constant so what actually happens is that supply is greater than the demand.

So money market is in disequilibrium situation so in order to bring money supply exactly equal to money demand interest rate needs to be decline and we will be back in the equilibrium position, so it would be reflected in the LM curve by shifting it to the right. Keeping the income fixed. it is said when interest rate is low speculative demand for money is high in the economy because when interest is low and people expect it to rise in future say fall in price of bond anticipating capital loss from bond holding, people convert their bonds into money in order to avoid future capital loss.

2. changes in demand for money how it leads LM curve to shift.

b) LM curve tends to shift left

when demand for money in the economy increases or shift upward in that case interest rate also increases and LM curve shift to left so over here speculative demand decreases because when interest rate is high people will purchase bonds as they know that the prices of the bonds will be low.

e.g, I have already purchased the bond at Rs 100 and now interest rate is high in the market so same bond price has come down to say 50 rupees so if now I go to sell my bonds in the market, I will be incurring 50 rupees loss.

If market rate of interest is very high and everyone expects it to fall in the future as people know that price of bonds will increase thereby anticipating capital gain or profits from bond holding, people will convert their money into bonds. Thus, speculative demand for money is low.