Quadrant II - Notes

Paper Code: ECC 104

Module Name: Concept of IS curve and derivation of IS functions

Module No: 1

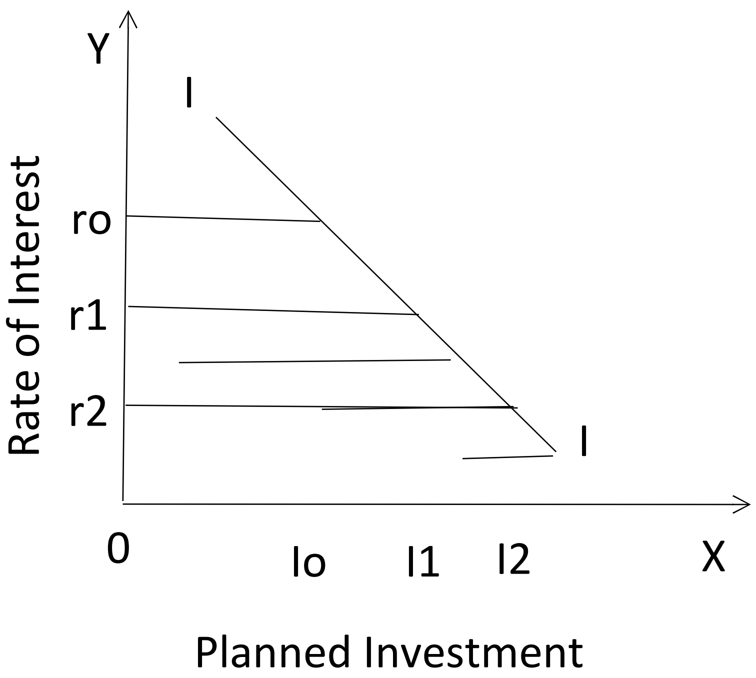
CONCEPT OF IS CURVE:

- The term IS stands for investment – saving.
- It represents the product or the goods market equilibrium.
- It shows the combinations of interest rates and income levels where saving –investment equality takes place so that the product market of the economy is in equilibrium.
- It is also known as 'real equilibrium'.
- **The IS curve is the locus of those combinations of rate of interest and the level of national income at which goods market is in equilibrium**

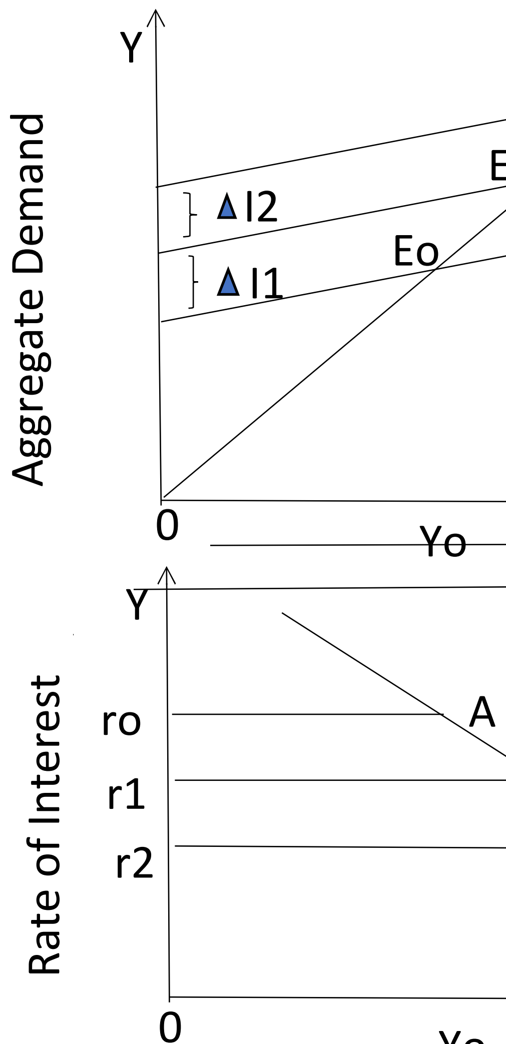
DERIVATION OF THE IS CURVE:

- The goods market is in equilibrium when aggregate demand is equal to income.
- AD = C + I.
- When the rate of interest falls the level of investment increases and vice versa.
- Thus, changes in the interest rates affect aggregate demand by causing changes in the investment.
- When the interest rate falls, it lowers the cost of investment projects and increases the profitability of investment.

- The businessmen will therefore undertake greater investment at a lower rate of interest.
- The increase in investment demand will bring about an increase in aggregate demand which will raise the equilibrium level of income.
- Thus the IS curve relates different equilibrium levels of national income with various rates of interest.
- With a fall in the rate of interest, the planned investment will increase which causes an upward shift in aggregate demand function(C + I) resulting in goods market equilibrium at a higher level of national income.



Panel (a)



Panel (c)

- In Panel (a) the relationship between rate of interest and planned investment is depicted by the investment demand curve II
- When the rate of interest is ro the planned investment is equal to Io.
- With Io as the amount of planned investment, the aggregate demand curve is C + Io which equals aggregate output at Yo level of national income as shown in Panel(b)
- Therefore in panel (c) against the rate of interest ro, level of income equal to Yo has been plotted.
- Now, if the rate of interest falls to r1, the planned investment by businessmen increases from Io to I1 and the aggregate demand curve shifts upward to C + I1 and the goods market is in equilibrium at Y1 level of national income.
- Thus in panel (c) the level of national income Y1 is plotted against the rate of interest r1.
- With the further lowering of interest rate to r2, the planned investment increases to I2 and the aggregate demand curve shifts further upwards to C + I2 corresponding to which goods market is in equilibrium at Y2 level of income.
- Therefore, in panel (c) the equilibrium income Y2 is shown against the interest rate r2.
- By joining points A, B, D representing various interest – income combinations at which goods market is in equilibrium we obtain the IS curve.
- The IS curve is downward sloping which implies that when rate of interest declines, the equilibrium level of national income increases.