

The Small Open ISLM Economy

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This monograph introduces the workhorse macroeconomic ISLM model of an economy open to international trade and investment. It is appropriate for advanced undergraduates or beginning graduate students wanting a precise but concise introduction. Email thomph1@auburn.edu for more information.

Introduction

The applied side of macroeconomics is based on models that capture aggregate economic behavior and the response of the economy to external shocks such as rising energy prices, financial system bankruptcy, global recessions, exchange rate shocks, and erratic government monetary and fiscal policies. The ISLM model remains the workhorse model for such applied macroeconomic issues.

The present introduction to the ISLM model focuses on a small economy open to international trade and investment. The IS in ISLM refers to the equilibrium between investment and saving in the real economy. The LM represents the equilibrium between liquidity and money supply in the monetary economy. The advantage of the ISLM model is that it integrates real and monetary issues. The ISLM model includes common aggregate measures such as consumption, investment, government spending, taxes, exports, imports, interest rate, exchange rate, and national output or income in a consistent theoretical framework.

The ISLM model is not comprehensive. It does not include optimal decision making by households, firms, and government as in microeconomic optimization models. ISLM does not include production or distribution of income among labor and capital as in general equilibrium models. The ISLM model does not include optimal economic growth. Even regarding its main applications to policy issues, ISLM falls short by not explicitly including models of unemployment and inflation.

Regardless of these shortcomings, the appeal of ISLM is its description of how the major macroeconomic variables in an economy are related. The time horizon of the ISLM model is up to a

few quarters or a year. The ISLM model remains the primary model used by government policy makers, financial commentators, and macroeconomic consultants.

This introduction presents the open economy ISLM model focusing on the role of government policy to influence output. A range of government policies are considered including fiscal policy of government spending and taxes, monetary policy of the money supply, and exchange rate policy in the choice of a fixed or floating exchange rate. Inflation is not modeled explicitly in the ISLM model but its effects are included. A small open economy is assumed to be a price taker in the international credit market, fixing the interest rate at the global level. Adjustments in the balance of trade and international investment in the capital account are analyzed along with adjustments in output. The exchange rate regime, floating or fixed, is critical to the adjustment process.

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Conclusion

Economists are divided according to whether they are policy activists or rely on market forces. Some economists advocate fixed exchange rates, some floating exchange rates. Some favor monetary policy to manage the economy, others fiscal policy with the focus on either government spending or taxes. Some favor active monetary policy or active fiscal policy to manage economies, while others see government mismanagement as a primary cause of economic problems. The economic approach to fiscal policy is to define the role for the government and levy taxes to support that level of government spending.

The main point to remember in this introduction to ISLM is that the choice of a floating or fixed exchange rate regime determines the effectiveness of monetary policy versus fiscal policy. Without any doubt, free trade and free international investment are the best policies for economic growth. Active monetary or fiscal policy can offer short term temporary nudges for the economy but do nothing to improve long term economic performance.