Answer on Question #38019 - Economics – Macroeconomics

Increase in the supply of money will shift the vertical LM curve from LM1 to LM2 and thus achieve a new equilibrium at point F, where we see output has risen from Y1 to Y2 and the rate of interest fallen from r1 to r2. Notice that since we have a vertical LM curve, then aggregate demand movements will not affect output. For instance, if government spending increases so that IS1 shifts out to IS2, as the LM1 curve is unchanged, then we must climb back up the IS2 curve to the new equilibrium G where output remains the same (at Y1) but interest rate has risen from r1 to r3. Thus, in the vertical LM curve characterization of Monetarism, movements in money supply drive movements in output while fluctuations in aggregate demand only affect interest rates and have no effect on output. The policy implications, then, are that only monetary policy is effective, while fiscal policy is completely ineffective.