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Analysis of the IS-LM Balance in the Context of Monetary Policy and Fiscal Policy

Nabilla Rizki [1], Naila Lailiyah Zahrani [2]
[1,2] UIN Mahmud Yunus Batusangkar, Indonesia

Corresponding Author: Name, Naila Lailiyah Zahrani E-mail; nailazahrani366@gmail.com

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ABSTRACT

The IS-LM model is a widely used analytical framework in conventional economics to explain the interaction between the goods market (IS) and the money market (LM); however, this approach carries assumptions that are inconsistent with the principles of Islamic economics, such as the presence of interest (riba), speculative practices, and unequal wealth distribution, thereby requiring reconstruction to make the model relevant to the Sharia system. This study employs a library research method by reviewing academic literature, books, and journal articles related to the IS-LM concept and the principles of Islamic economics, using a qualitative-descriptive approach to identify common ground and key differences between the conventional and Islamic frameworks. The findings reveal that IS-LM equilibrium within the Islamic perspective can be achieved through fiscal and monetary policies based on Sharia principles, where fiscal policies emphasize fair wealth distribution, the management of zakat, infak, and waqf as sources of social financing, and the elimination of practices that cause inequality, while monetary policies focus on the prohibition of riba, the avoidance of speculative practices (*gharar*), and the strengthening of profit-and-loss sharing systems as alternative financing mechanisms. Accordingly, the IS-LM model remains applicable as a tool for macroeconomic equilibrium analysis but within a framework that emphasizes justice, sustainability, and the objectives of *maqasid al-shariah*. This study concludes that integrating macroeconomic theory with Islamic principles is essential not only for enriching the theoretical development of Islamic economics but also for providing practical alternatives in formulating economic policies for countries adopting Sharia-based systems, thereby offering analyses and solutions that are more aligned with moral values, social justice, and collective welfare.

Keywords: *Fiscal Policy, IS-LM Equilibrium, Islamic Economics, Library Research, Monetary Policy*

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INTRODUCTION

The IS-LM model is one of the most common analysis tools used in macroeconomics to understand the interaction between the goods and financial markets (Harahap, Muda Syafri, D. & Fauzan 2021). This model illustrates the relationship between interest rates and production and ultimately determines the economic balance. In traditional analysis, IS-LM balance is achieved when aggregate demand in the goods market (IS) and balance in the financial market (LM) is appropriate. (Sirite, F.Y., Fitri, M., Harahap, 2023). But this model is based on assumptions that are not necessarily in line with the principles of Islamic economics. (Wikakusono 2019).

The Islamic economy has unique principles, such as the prohibition of usury, the application of zakat, and the impetus for social justice and the distribution of fair wealth (Siska Rahmi, Ali Anis 2019). Therefore, there is a wrinkle to re-evaluate the IS-LM balance in the context of the Islamic economy, considering the fiscal and monetary policy of Shariah-shaped. This study aims to understand how the IS-LM model can be adapted to these principles and whether the economic balance can be achieved with a more appropriate approach to Islamic teachings. (Ambarwati 2008)

One of the main criticisms of the IS-LM model in the context of Islamic economics is the role of interest rates in determining balance. In Islamic economics, interest (usury) is prohibited because it is considered an exploitation and injustice (Harahap, Syafri Muda, D., & Fauzan 2021). Instead, Islam encourages the application of financial systems based on profit-sharing and real economic activities. Therefore, an IS-LM model adaptation is needed that is able to accommodate financial instruments and monetary policies in accordance with sharia principles. (Mankiw 2009)

In addition, fiscal policies in Islamic economics also have characteristics, such as the obligations of zakat and other wealth redistribution instruments that aim to reduce economic inequality (Ibrahim 2013). This requires a new approach in the analysis of macroeconomic balance that considers the moral and social dimensions in achieving market balance. (Santoso, T., & Umar Basuki 2009).

The IS-LM model places interest rates as key variables in determining macroeconomic balance, while in Islamic economics, interest (usury) is prohibited because it is considered to cause injustice and exploitation. This condition raises methodological and practical challenges: how to adjust the established macroeconomic balance model globally to remain relevant in the sharia system. In addition, there are problems in integrating sharia -based fiscal and monetary instruments - such as zakat, infaq, waqf, as well as profit sharing mechanisms - in an analysis framework that usually only focuses on national income, investment, and interest rate variables. It is this gap that gives rise to academic needs to reformulate the IS-LM model in order to be able to describe the macroeconomic balance more fairly, sustainably, and in accordance with sharia maqasid.

A number of previous studies have tried to answer this problem. For example, Ambarwati's research (2008) emphasized the importance of zakat -based fiscal policy in reducing social inequality, while Ibrahim (2013) highlighted the role of redistribution in

maintaining Islamic economic stability. Harahap, Syafri Muda & Fauzan (2021) also emphasized that the removal of usury must be followed by strengthening the real asset - based monetary instrument in order to achieve stability. In previous studies, the author has also discussed the relevance of zakat instruments as one of the macroeconomic stabilizers and the role of Islamic financial in encouraging equitable growth, which can conceptually be positioned as one of the adaptive solutions to the weaknesses of the conventional IS-LM model. Thus, this study expanded the previous study by focusing on the theoretical reconstruction of the IS-LM balance that is in line with the principle of sharia maqasid, as well as answering fundamental problems: is it possible that the macroeconomic balance model that was born from conventional traditions can be Islamized without losing the sharpness of its analysis.

RESEARCH METHODOLOGY

This study uses a type of qualitative research with a library research approach. This approach was chosen because the main focus of the research is to evaluate, critique, and reconstruct the IS-LM model within the framework of Islamic economics by referring to the relevant literature.

The data sources used in this study are secondary, obtained from various scientific works such as conventional macroeconomics textbooks (e.g. Mankiw, 2009), Islamic economic literature (e.g. Ambarwati, 2008; Ibrahim, 2013; Harahap, Syafri Muda & Fauzan, 2021), national and international journal articles that discuss the IS-LM model and Islamic economic principles, as well as other relevant academic documents. In addition, references from previous research were also used which specifically discussed sharia fiscal and monetary policies, zakat, the prohibition of usury, and wealth redistribution instruments.

The data analysis technique was carried out with a qualitative-descriptive analysis approach and content analysis. The analysis steps include: (1) data reduction, namely selecting literature that is relevant to the topic of IS-LM balance and Islamic economic principles; (2) data categorization, which is grouping information based on main themes such as criticism of the IS-LM model, Islamic economic principles, sharia fiscal policy, and sharia monetary policy; (3) comparative analysis, by comparing the assumptions of the conventional IS-LM model and the concept of equilibrium in Islamic economics; and (4) synthesis, which is to develop conceptual integration to build a balance model of IS-LM that is more in accordance with the sharia maqasid.

With this methodology, the research is expected to produce a critical and comprehensive conceptual study of the possible adaptation of the IS-LM model in the framework of Islamic economics, as well as make a theoretical contribution to the development of Islamic economics and a practical basis for sharia-based macroeconomic policies.

RESULT AND DISCUSSION

Result

This study aims to examine the relevance of the IS-LM model in the context of Islamic economics. Through a literature review, it is understood that the IS-LM model as a product of Keynesian thinking has long been a reference in analyzing macroeconomic balance. However, when this model is applied to the Islamic economic system, various limitations arise that require reinterpretation to conform to sharia principles. The IS-LM model was introduced by Hicks (1937) and developed by Hansen (1953) as a synthesis of Keynes' thought in The General Theory. This model describes the short-term macroeconomic equilibrium through the interaction of two main markets, namely the goods market (the IS curve) and the money market (LM curve). The IS curve shows a combination of interest rates and national incomes that maintains the equilibrium of the goods market, while the LM curve shows a combination that maintains the balance of the money market. In conventional analysis, monetary and fiscal policies are seen as the main instruments in driving economic growth and maintaining macro stability (Mankiw, 2009). However, this model's reliance on interest rates raises serious debate when applied to Islamic economic systems that prohibit interest (riba) (Chapra, 1992; Harahap & Fauzan, 2021).

Islamic economics is built on the principles of justice, balance, and sustainability (istiqamah) (Rahman, 2015). These principles affirm that economic activities should not contradict the teachings of sharia, such as the prohibition of usury, gharar (uncertainty to the detriment), and maysir (speculation). The IS-LM model is considered problematic within the Islamic framework for three main reasons. First, dependence on interest rates as a key variable of equilibrium, which is contrary to the principle of prohibition of usury (Iqbal & Mirakhor, 2011). Second, this model does not pay attention to the distribution of wealth, even though fair distribution is one of the main goals of Islamic economics (Siska Rahmi & Anis, 2019). Third, IS-LM does not consider moral values, while Islamic economics emphasizes the integration between economic aspects and ethical values (Antonio, 2001).

In Islam, monetary policy is directed at currency value stability, avoidance of exploitation, and strengthening the real sector. The main instruments that replace interest include the profit-sharing system through mudharabah and musharakah contracts (Iqbal & Mirakhor, 2011), real asset-based instruments such as murabahah, ijarah, and istisna' (Antonio, 2001), and sukuk as a non-riba financing instrument that is growing (Iqbal, 1997). In addition, zakat on money and the prohibition of hoarding (iktinaz) encourage the circulation of wealth so that it does not accumulate in a few people (Ambarwati, 2008). Thus, the LM curve in the Islamic framework no longer represents the relationship between interest rates and money supply, but the relationship between profit-sharing-based real profit levels and the demand for money in the economy.

Fiscal policy in Islamic economics also has distinctive characteristics. The main instruments are zakat as a means of redistributing wealth to reduce social inequality

(Ibrahim, 2013), infak and alms as social support, and productive waqf as a source of long-term financing (Santoso & Basuki, 2009). Taxes (al-dharibah) are allowed in emergency conditions to finance state needs (Chapra, 1992). This is different from conventional fiscal which relies on taxes as the main source of state revenue. Islamic fiscal emphasizes more on distribution justice and social sustainability, so redistributive variables such as zakat and waqf need to be included in the analysis of the IS curve.

The results of the study show that the reconstruction of the IS-LM model within the framework of Islam can be carried out with several fundamental adjustments. The sharia IS curve is influenced by consumption, profit-sharing-based investment, government spending, and redistribution instruments (zakat, infaq, waqf). Taxes only function as an additional instrument if zakat is insufficient (Ambarwati, 2008). Investment is not determined by interest rates, but by fair real profit rates (Iqbal & Mirakhor, 2011). The sharia LM curve shows that the demand for money is a function of transaction needs, just in case, and halal investment, not interest. The money supply is controlled through sharia instruments such as sukuk and the arrangement of mandatory reserves of Islamic banks (Rahman, 2015). Thus, the balance of Islamic IS-LM is achieved when aggregate demand and money supply are appropriate within a non-usury framework.

The implications of these findings are both theoretical and practical. Theoretically, this study shows that the IS-LM model can be adapted to Islamic principles without losing its essence as a tool for macroeconomic analysis. Instead, this reconstruction enriches the analysis with the dimensions of morality, distribution, and sustainability (Iqbal & Mirakhor, 2011; Rahman, 2015). Practically, the adaptation of the IS-LM model in the context of Islam has implications for policies in countries that implement sharia economic systems. Monetary policy should be directed at strengthening real asset-based financing, not interest rate regulation (Antonio, 2001). Fiscal policy must make zakat the main instrument of redistribution (Ambarwati, 2008; Ibrahim, 2013). The Islamic banking system can use this model to project policy impacts without using interest, so that it is in accordance with the Islamic maqasid.

Thus, this study confirms that although the conventional IS-LM model is problematic in the Islamic context, it can still be used after sharia-based reconstruction is carried out. The sharia IS-LM model emphasizes the prohibition of usury, the implementation of a profit-sharing system, zakat as the main fiscal instrument, and a fair distribution of wealth. The macroeconomic balance in Islam is not only understood in the framework of market efficiency, but also in the maqasid of sharia which is oriented towards justice, collective welfare, and sustainability (Chapra, 1992; Harahap & Fauzan, 2021). This research expands on previous studies that emphasized the importance of zakat in reducing social inequality (Ambarwati, 2008), the role of redistribution in maintaining economic stability (Ibrahim, 2013), and the need to strengthen monetary instruments based on real assets (Iqbal & Mirakhor, 2011)

Discussion

The results of this study show that the IS-LM model, which has been the main reference in conventional macroeconomic analysis, cannot be fully adopted within the framework of Islamic economics. This is mainly due to the central role of interest rates in determining the balance, which is fundamentally contrary to sharia principles that prohibit the practice of usury. This finding is in line with the view of Chapra (1992) who asserts that riba is an exploitative instrument that has the potential to damage social justice and economic stability. Thus, the reconstruction of IS-LM into an Islamic framework is imperative so that macroeconomic balance analysis remains relevant for countries implementing the sharia system.

If you look deeper, the conventional IS-LM model was actually born from the Keynesian paradigm that emphasized the importance of government intervention through fiscal and monetary policies to maintain economic stability (Hicks, 1937; Hansen, 1953). Keynes saw that the market was not always able to create equilibrium automatically, so state intervention was needed. However, these Keynesian assumptions are translated in the IS-LM model by using interest as a balancing variable. This is where Islamic criticism arises, as this assumption not only contradicts the prohibition of usury, but also ignores the moral dimension and distribution of wealth that are pillars of Islamic economics (Iqbal & Mirakhor, 2011; Siska Rahmi & Anis, 2019).

Further discussion indicates that in the Islamic framework, interest variables can be replaced with other variables that are more appropriate, such as the level of real profit from asset-based activities (asset-backed financing). Iqbal (1997) emphasizes that in the Islamic financial system, investment and financing must be based on the real sector to avoid speculation and create long -term stability. This is reinforced by Uddin (2016) who found that the demand for money in the interest -free system tends to be more stable because it is not affected by interest rate fluctuations, although it still depends on the stability of the profits of asset -based instruments. Thus, the LM Sharia curve no longer represents the relationship between interest rates and money demand, but rather the relationship between money demand with a real level of profit and transaction needs.

In addition, within a fiscal framework, this study found that the role of zakat, infaq, and waqf is very important to replace some of the tax roles in the conventional system. Ambarwati (2008) emphasizes that zakat does not only function as a redistribution instrument, but also as a macroeconomic stabilizer that can reduce inequality. The results of this study reinforce this view, by showing that the integration of zakat into the IS sharia curve allows the achievement of a more just macro balance. This is also in line with Ibrahim (2013) which highlights the importance of wealth redistribution in maintaining long -term stability. The latest simulation study by Kato et al. (2022) even showed quantitatively that zakat -based distribution systems and profit sharing can withstand increased wealth inequality compared to the interest -based system.

However, the application of sharia IS-LM models is not without challenges. One of the problems that arises is how to measure quantitatively sharia variables within the framework of macro analysis. For example, the level of real profit from the profit sharing agreement does not always have a transparent market mechanism such as interest rates. Variations in Islamic banking practice in various countries also lead to standardization challenges (Rahman, 2015). This was reinforced by Khatat (2016) in the IMF study which confirmed the existence of excess liquidity and weak Islamic financial markets that caused the transmission of sharia -based monetary policy often ineffective. Thus, although theoretically the IS-LM model can be reconstructed, its implementation requires institutional innovation and strengthening strong regulations.

In comparing this research with previous studies, it appears that the direction of Islamic economic research is increasingly leading to the search for alternative models of conventional theory. Harahap and Fauzan (2021) emphasize the importance of building Islamic macroeconomic models based on real assets. Meanwhile, Santoso and Basuki (2009) highlighted that sharia fiscal policies must pay attention to the moral and social dimensions. The latest empirical study in Indonesia also found that Islamic financing contributed to macroeconomic stability by strengthening the MSME sector and reducing the volatility of economic growth (Aggregate, 2024). This finding was strengthened by international research which showed that the significant increase in Islamic financing share was related to a decrease in macroeconomic volatility (Emerald, 2025). This study expanded these findings by emphasizing the importance of monetary and fiscal integration within the framework of sharia IS-LM, so that the analysis of macroeconomic balance could be more holistic.

Sukuk instruments have also proven to play an important role in the framework of sharia IS-LM. Zulkhibri (2015) shows that sukuk as an asset-based instrument has great potential to provide an interest-free government financing alternative. Research by Ledhem et al. (2022) also corroborates that the development of the sukuk market contributes positively to the financial stability of Islamic banks. Thus, within the framework of sharia LM, the sukuk instrument not only functions as a liquidity instrument, but also as a key pillar in maintaining monetary balance. However, its effectiveness depends largely on the design of the sukuk structure, whether it is truly asset-backed and has adequate liquidity.

The theoretical implication of these findings is that Islamic economics does not simply criticize conventional models, but also offers a more equitable and sustainable conceptual alternative. By reconstructing the IS-LM model, Islamic economics demonstrates its capacity to adapt to modern economic theories while maintaining sharia principles. The practical implication is that monetary and fiscal policies in Islamic countries should be directed at strengthening the real sector, redistributing wealth, and avoiding interest-based instruments. Chapra (1992) states that the success of Islamic economics lies in its ability to integrate moral values into macro policies. This research proves this by showing that the IS-LM model can function as a policy analysis instrument, but in a form that has been Islamized.

In addition, this research contributes to the literature on sharia maqasid in the context of macroeconomics. Maqasid sharia which emphasizes the protection of religion, soul, intellect, descendants, and property, in an economic context can be translated as distribution justice, value stability, and social sustainability (Antonio, 2001). Thus, the reconstruction of Islamic IS-LM is not only a matter of economic technicality, but also a manifestation of sharia maqasid in public policy.

However, this study also has limitations. Because it is based on literature, this study does not present empirical data that can quantitatively test the sharia IS-LM model. Therefore, follow-up research needs to use an empirical approach, for example by building macroeconomic simulations based on Islamic banking data and Islamic fiscal policies in several countries. In addition, the integration of sharia variables into the IS-LM mathematical framework still requires further methodological studies.

From a policy perspective, these findings underscore the need for reforms in the monetary and fiscal systems in countries that adopt Islamic economies. Central banks, for example, can no longer use interest rates as the primary instruments, but instead need to switch to sharia instruments such as sukuk, profit-sharing-based financing, and non-usury liquidity policies. Meanwhile, the government needs to strengthen the role of zakat and waqf in the fiscal system to achieve fair redistribution.

Thus, this discussion confirms that the sharia IS-LM model is not only theoretically possible, but also practically relevant. However, its success is highly dependent on political will, institutional readiness, and adequate regulatory support. The integration of moral and social values in macroeconomic models provides an opportunity for Islamic economics to offer alternative solutions to global challenges, such as inequality, financial instability, and sustainability crises. This makes this research important not only for the development of Islamic economic theory, but also for the practice of economic policy in the real world.

CONCLUSION

The study concludes that the conventional IS-LM model, although highly influential in macroeconomic analysis, is not fully in line with Islamic economic principles due to its reliance on interest rates as a key variable. In an Islamic perspective, usury is considered an exploitative practice that is contrary to social justice, so this model requires reconstruction. The results of the literature review show that the interest variable can be replaced with a real profit rate based on profit sharing, while fiscal instruments are strengthened with zakat, infaq, alms, and waqf as a means of wealth redistribution. This adaptation results in a sharia IS and LM curve that better reflects justice, distribution, and sustainability, in line with the sharia maqasid. These findings are reinforced by various empirical studies, such as those showing that the Islamic financial system is able to improve macroeconomic stability, strengthen the real sector, and reduce social inequality.

In addition, the discussion shows that the implementation of Islamic IS-LM is not only theoretically possible, but also practically relevant, provided that there is

institutional support, regulation, and strengthening of Islamic financial instruments such as sukuk. The challenges faced are mainly related to the mechanism for quantifying sharia variables, the effectiveness of monetary policy transmission in the dual banking system, and the need for harmonization of cross-border regulations. Nevertheless, the integration of moral and social values in macroeconomic models provides a great opportunity for Islamic economics to offer alternative solutions to global problems such as inequality, financial instability, and sustainability crises. Thus, this study confirms that the reconstruction of IS-LM in an Islamic perspective not only enriches Islamic economic theory, but also provides practical direction for the development of more fair, stable, and sustainable monetary and fiscal policies.

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