INTRODUCTION: QUO VADIS IS-LM?

IS-LM has been described in a number of ways. Dornbusch and Fischer termed it the “core of modern macroeconomics”, Patinkin deemed it as the “central message” of Keynes, Solow called it “the trained intuition” of the economics profession, while one of the editors of this volume described it as a “chimera”. The focus of the essays presented in this book is, in the main, on the closed-economy version of IS-LM, as against the open economy Mundell-Fleming approach. The reasons for this, in our view, are clear. Firstly, the closed economy model developed almost two decades prior to the Mundell-Fleming model. Indeed, the Mundell-Fleming model has its own history and development. Secondly, the open economy model is only one example of IS-LM’s “chameleonic nature” or, as the present editors would now say, its “putty” characteristic, that is to say, its ability to be “augmented”. Thirdly, IS-LM is, in our view, essentially a general equilibrium model and therein lies its ability to serve not only as the basis of the development of more sophisticated general equilibrium macromodels, ranging from Patinkin through AD-AS, but enables its augmentation via rational expectations into a long-run “full employment” model. It is as if IS-LM did not exist, to paraphrase the old saying, “its invention” would be “warranted”; and this, due to its androgynous nature, combining the “Classics” and Keynes. There are a number of key issues, therefore, that must be dealt with here. Among these are:

- whether Macroeconomics will continue to develop with IS-LM as its “core” model;
- whether or not the IS-LM model is “dead” or still “alive”, albeit in augmented form; and, if “dead”, can be resurrected by augmentation;
- whether Macroeconomics could have developed without IS-LM and related elements, such as the Aggregate Demand and Supply Curves.

We have deliberately opened the volume with an important survey essay by Dixon and Gerrard focusing on “Old, New and Post Keynesian Perspectives”, which calls into question the very efficacy of what they call “the IS-LM framework” for modern macroeconomics. Their “general conclusions”, given at the beginning of their paper, are “that the IS-LM model has become a largely irrelevant framework in mainstream economics” and “to a certain extent, the IS-LM model is ‘dead’ as a framework for contemporary macroeconomic research”. In the concluding section of their paper, they reiterate these statements, saying that “the IS-LM model has become marginalized ... [and] has gone out of fashion in modern mainstream macroeconomics”. But they end their paper by saying that “An augmented IS-LM model [our emphasis], based on the microeconomics of intertemporal optimization and allowing for the supply of output to be directly affected by labor-supply adjustments in
response to changes in the rate of interest, may feature more prominently in the near future, in the textbooks at least”. In this essay, Dixon and Gerrard do not discuss in detail the Monetarist and New Classical models, even though as they note, these approaches initially utilized an IS-LM framework in their debate with the Keynesian approach. What Dixon and Gerrard do stress, however, is that IS-LM has been “augmented” in the past, and—in its augmented form—will remain an important part of the analytical toolkit of economists, at least at the pedagogical level.

The essay following Dixon and Gerrard, by Colander, actually complements, rather than contradicts their final conclusion regarding the pedagogical efficacy of the augmented form of IS-LM. In his essay, Colander tries to outline the relationship between his vision of “Post Walrasian Macroeconomics” and IS-LM from the perspective of “the pedagogical use of the IS-LM framework”. What Colander attempts to do in his paper is to synthesize, as he puts it “the vision of traditional macroeconomists such as Tobin, Friedman, Keynes, Hayek, and Lerner” with the IS-LM framework to develop what he calls “Post Walrasian IS/LM analysis” for pedagogical purposes. Colander’s augmented IS-LM model, therefore, encompasses “complex dynamics” and its related “multiple equilibria”, and is one which “can change the pedagogical use of IS/LM analysis”; something which, as we said, actually complements the Dixon-Gerrard approach.

The two papers that follow, by Heathfield and Barens respectively, deal with the issue of Aggregate Demand. This is an important issue, for as Dixon and Gerrard write “the IS-LM model still appears in undergraduate macroeconomic textbooks but increasingly it is used as a mere stepping stone in the construction of the aggregate demand schedule”. In Heathfield’s view, “supply side dominance” has resulted in the neglect of demand “policies”. In his paper, he proceeds to develop a model based upon neo-classical assumptions with fully flexible prices and wages, perfect competition, profit maximization, full information, an auctioneer and a “well behaved” aggregate production function. And this, as he writes in his conclusion, in order to “focus attention on what might be meant by a Keynesian aggregate demand curve and to demonstrate its use in explaining persistent, involuntary unemployment in...flexible price models which obey all the usual assumptions of the neo-classical model”.

In his paper, Barens takes the position that the “Aggregate Demand Curve” does not necessarily follow from the IS-LM model of “Hicksian” vintage. Rather, in Baren’s view, its introduction “to augment the fix price IS-LM analysis of macroeconomics textbooks to allow” the discussion of “the endogenous determination of the price level” has, in his opinion, raised more “problems” than it has solved, especially on the pedagogical level. Barens attempts to show that “if one adheres to the modeling approach” as it appears in the original Hicksian model, not only is the “textbook” Aggregate Demand Curve “not needed for the determination of the price level”, but that it “cannot even be constructed”. In other words, as Barens notes, if IS represents goods market equilibrium “the textbook AD cannot be constructed”. If, on the other hand, “the IS curve is not constructed to be the goods market equilibrium curve—as is the case in many textbooks—one may derive the textbook AD curve”. This raises the question, as Barens puts it “What is this textbook AD curve?” and Barens attempts not only to provide the answer but to show that there is a basic