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IS-LM AND LEIJONHUFVUD’S RE-APPRAISAL

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6.1 INTRODUCTION

Many economists have reflected on the virtues and limitations of IS-LM. Axel Leijonhufvud has centered much of his work on the extent to which Keynes’s insights can be, and have been, conveyed by mainstream economists and their textbooks. He has attributed much of the strength of the revival of some forms of classical economics to the innate susceptibility of neoclassical Keynesianism to attack. The weaknesses of US mainstream Keynesianism can be traced to the gradual drift away from emphasising the most importantly anti-classical features of Keynes’s revolution, in particular, the multiplier and the malcoordination of saving and investment.

The IS-LM system has encouraged, or at least its use has resulted in, a theoretical and empirical focus on the elasticities of the curves.

Leijonhufvud maintains (1983, p. 65) that “IS-LM has served us ill in three long-lasting controversies”: namely Keynes and the classics, loanable funds versus liquidity preference and the empirical validity of monetarism. One could add that renewed interest in the business cycle has proceeded without IS-LM being integral. Dialogue with the Austrian school has not been fostered, but, at one level, real business cycle stories can be depicted. But, despite its shortcomings, Leijonhufvud (1983, p. 64) accepts that “in the teaching of macroeconomics, a better mousetrap has yet to be invented”.

Leijonhufvud’s first objection is the most well known: IS-LM came to view Keynes and the classicists as disagreeing primarily about the elasticities of the curves, and, in the long run, elasticities did not matter anyway because wage flexibility would ensure their intersection over full-capacity output. While Keynes devoted much of the General Theory to the determination of interest rates, textbooks
ended up with the notion that, to Keynes, they did not matter. Whether elasticities were large or small was empirically testable. Formalism, the mode of analysis rejected by Keynes himself, became the academic and scientific style post-war. It resulted in a drift away from grasping the intuition, the essentialist overtones of which positivists distrust. The rise of the technocratic econometrician and the Walrasian theorist, with their quest for precision and rigour, facilitated the language, IS-LM, being appropriated by the users who had something else (better, in their minds) to say. Keynes's preoccupation with market speculation over interest rates in a deeply uncertain world was replaced by the banality of transactions costs as a means to flatten LM, for example. Pragmatism displaced insight.4

In his writings since his 1968 book Leijonhufvud has complained that IS-LM analysis has been used too mechanically insofar as the interdependencies and sympathetic shifts of the curves are typically suppressed. Increases in expenditure have clear and predictable financial implications of which wealth holders presumably could quickly become aware. Some post Keynesians, it may be said, use IS-LM to good effect; e.g. Davidson (1978) shows how Keynes's finance motive for holding money can be incorporated to show that shifts in IS caused by investor confidence leads to an immediate change in the demand for bridging funds. What perhaps doesn't make sense is the simultaneous belief by mainstream economists in IS-LM and in Walrasian notional demands. The question is whether spillovers and effective demands can be captured by IS-LM. One curve need not sit still while the other is manipulated. It becomes a question of learning and anticipation.

Leijonhufvud's point is that sometimes monetary disturbances have real consequences and sometimes real ones have monetary and financial consequences. One of the problems with IS-LM stories based on the standard, extreme assumptions about elasticities that are told by fiscalist Keynesians and monetarists is that their respective and rival consequences always are claimed to happen (1983, p. 75). For example, "monetarism" (flat IS, vertical LM) requires that IS shocks never change income. If the dynamics in reality instead depend on the state of knowledge and degree of learning (and no one would disagree with this), then the "same impulse need not produce the same response every time it is repeated" (1983, p. 76). Both IS and LM can shift depending on who knows what when.

But is any of this a valid criticism of IS-LM per se? All languages and doctrines are susceptible to capture and to evolutionary change. Was IS-LM peculiarly susceptible? One could even playfully suggest that Keynes's Chapter 12, which some regard as the axis around which the General Theory revolves, has been exaggerated and distorted, for example, by Shackle. Can a long-run5 reversion to classical explanations of unemployment that centre on wage inflexibilities really be attributed to the use of IS-LM?

This paper argues that Leijonhufvud's critique of textbook Keynesianism is even more valid now than it was in 1968 when he wrote his book. Samuelson's spirited rejection of Leijonhufvud is explored briefly. Furthermore, Leijonhufvud's case can be extended: textbooks do a poor job of explaining classical economics both when IS-LM and the related AS and AD approaches are used. Too many recent controversies between Keynesians and classicists have little to do with empirical disagreements over elasticities. Leijonhufvud's more recent objections to IS-LM have re-