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IS-LM Model Summary

- A way to visualize equilibrium in Keynes' General Theory, created by John Hicks.
- Stands for "investment-savings" and "liquidity preference-money supply": these are the two curves on the model.
- The graph plots GDP on the horizontal axis and interest rates on the vertical axis.
- IS curve: the relationship between GDP and interest rates when investment equals savings (I=S)
    - As interest rates go down, then savings (and thus investments if I=S) go up, so overal output and GDP go up. (The independent variable is interest rates, and the dependent variable is income level and investment.) Thus there is a negative slope in the IS curve.
- LM curve: the relationship between GDP and interest rates when liquidity preference is equal to money supply (L=M)
    - Liquidity preference is how much cash people want to have at hand, money supply is how much is available in banks.
    - As GDP goes up, people's income tends to go up, and generally they want more free money (higher liquidity) to be able to invest more or save for use in emergencies. To have the money supply match this liquidity, higher interest rates are needed. (The independent variable is income level, and the dependent variable is interest rates.) Thus there is a positive slope in the LM curve.
- Intersection of IS and LM curves are an equilibrium point between the real market (real production) and money market. (i.e., won't decrease interest rates further because of high money market demand, won't increase interest rates further because of negative impact to investment)
- It was later regarded to be not very realistic because it doesn't incorporate many factors, such as taxes, inflation, international markets, among other factors. John Hicks admitted that it was more of a "classroom gadget" representation.
- Also considered unrealistic because it treats the two curves as independent, whereas changes in one should cause changes in the other.