

# Intermediate Macroeconomics II

## Lecture 2: From RBC to IS–LM

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National Tsing Hua University

Spring 2026

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2026-02-18

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# Today: why we move from RBC to IS–LM

- Last time (RBC): output and the **real interest rate** are pinned down by **real** constraints and intertemporal choices.
- This semester's focus: **inflation and the price level** — so we must add a **nominal side**.
- IS–LM is our **first bridge model**:
  - IS = goods market equilibrium (a reduced-form view of intertemporal demand)
  - LM = money market equilibrium (how nominal variables enter)

**What you should be able to do after Lecture 2**

Explain how **goods demand** and **money demand** jointly determine  $(Y, r)$  in the short run, and how policy shifts the system.

## Lecture 2: IS–LM

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↳ Today: why we move from RBC to IS–LM

**Opening (1–2 min).** Remind students what last lecture delivered: a real allocation + a real rate.

**Motivation.** This semester is about  $P$  and  $\pi$ : we need nominal variables on the board.

**Learning goals.** Tell them: today is all about reading comparative statics from diagrams.

**Quick check.** Ask: “In RBC, what pins down the real interest rate?” (preferences/technology).

**Transition.** “IS–LM is not the final model—it is our first bridge to inflation.”

**Today: why we move from RBC to IS–LM**

- Last time (RBC) output and the **real interest rate** are pinned down by **real** constraints and intertemporal choices.
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- IS–LM is our **first bridge model**:
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Explain how **goods demand** and **money demand** jointly determine  $(Y, r)$  in the short run, and how policy shifts the system.

Recap: what RBC gives us

Money market and LM

Goods market and IS

Putting IS and LM together

Where we go next

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# Recap: what RBC gives us

Lecture 2: IS-LM

└ Recap: what RBC gives us

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Recap: what RBC gives us

# RBC in one slide: what we learned (and what we did *not*)

- **RBC core idea:** flexible prices  $\Rightarrow$  markets clear  $\Rightarrow$  output is tied to productivity and factor supply.
- The key intertemporal price is the **real rate**  $r_t$ :
$$1 = \beta \mathbb{E}_t \left[ \frac{u'(C_{t+1})}{u'(C_t)} (1 + r_t) \right].$$
- In that world, monetary variables are typically **neutral** for real allocations (classical dichotomy logic).

**So why add IS–LM?**  
Because once we care about **nominal interest rates, money demand, and the price level**, we need equations that speak to them explicitly.

Lecture 2: IS–LM

Recap: what RBC gives us

RBC in one slide: what we learned (and what we did *not*)

Emphasize dichotomy. RBC delivers  $Y$  and  $r$  from real forces; nominal side is absent/irrelevant for allocations.

Key phrase. “RBC is silent about the *price level* unless we add a nominal anchor.”

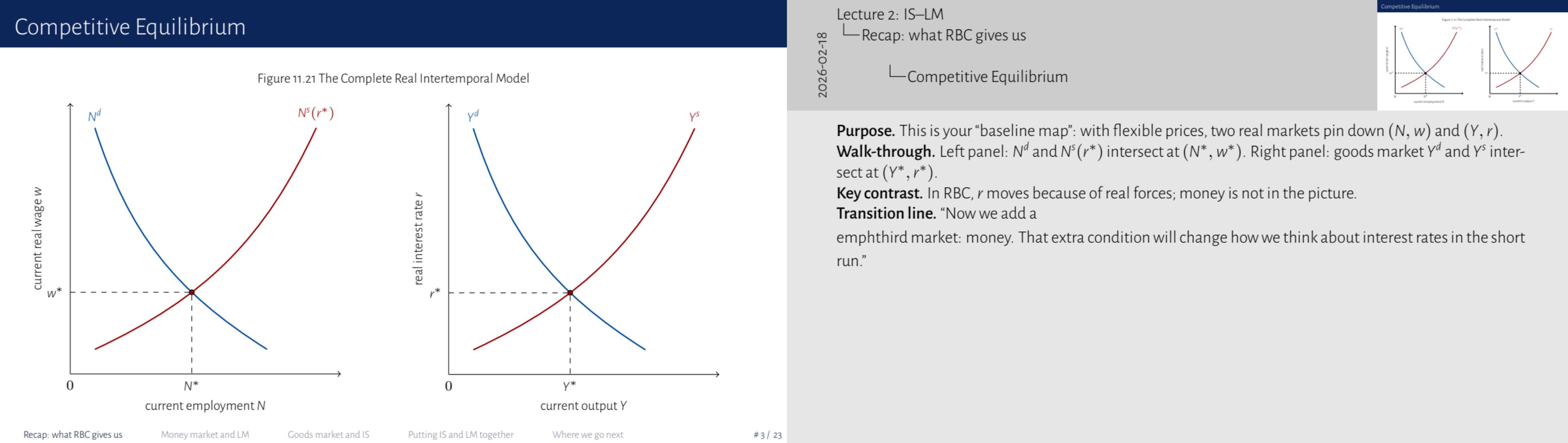
Bridge idea. IS–LM adds a money market and a nominal rate so we can start asking: what happens to  $Y$  and  $P$  when policy moves?

Pitfall to avoid. Students may think “money doesn’t matter” always—clarify: that is a property of the flexible-price benchmark.

RBC in one slide: what we learned (and what we did *not*)

- **RBC core idea:** flexible prices  $\Rightarrow$  markets clear  $\Rightarrow$  output is tied to productivity and factor supply.
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**So why add IS–LM?**  
Because once we care about **nominal interest rates, money demand, and the price level**, we need equations that speak to them explicitly.



# A clean map: same economy, more markets on the board

Think of the macro economy as **two big clearing conditions** plus a policy rule:

- **Goods market:** planned spending equals production (IS logic).
- **Money market:** money supplied equals money demanded (LM logic).
- **Policy:** central bank and fiscal authority pick instruments / regimes.

## Important perspective

IS-LM is a **different representation** that highlights **demand** and **nominal variables**. Later we replace its weak spots with NK microfoundations.

## Lecture 2: IS-LM

└ Recap: what RBC gives us

└ A clean map: same economy, more markets on the board

**Big picture.** Tell students: every macro model is “markets + policy.” IS-LM just chooses a different pair of markets to foreground.

**Board plan.** Draw two boxes on the board: (1) Goods market clearing (IS), (2) Money market clearing (LM). Add a third box called “Policy regime.”

**Expectation management.** Acknowledge limitations up front: IS-LM is intuition/benchmark; NK will microfound the same logic with expectations and price setting.

A clean map: same economy, more markets on the board

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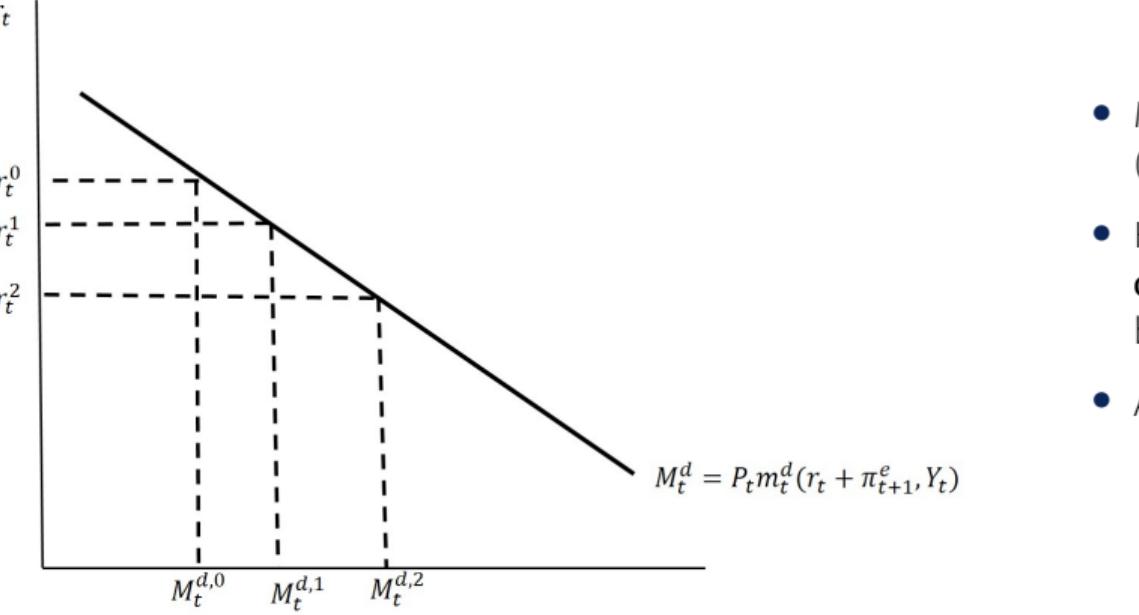
• **Policy:** central bank and fiscal authority pick instruments / regimes.

**Important perspective**

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# Money market and LM

## Step 1: Money demand (why people hold money)



- Money provides **liquidity** (transactions/convenience).
- Holding money has an **opportunity cost**: the interest you could earn on bonds.
- A standard reduced form:

$$\frac{M_t^d}{P_t} = L(Y_t, i_t), \quad L_Y > 0, \quad L_i < 0.$$

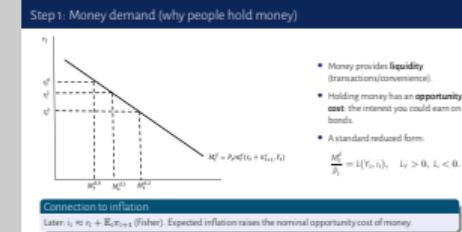
### Connection to inflation

Later:  $i_t \approx r_t + \mathbb{E}_t \pi_{t+1}$  (Fisher). Expected inflation raises the nominal opportunity cost of money.

## Lecture 2: IS-LM └ Money market and LM

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### └ Step 1: Money demand (why people hold money)



**Micro intuition.** Ask: "What is money good for if it pays (almost) no interest?" (transactions, liquidity).

**Key distinction.** Emphasize real money balances  $M/P$ : purchasing power of money holdings.

**Opportunity cost.** Bond versus money: when  $i$  rises, holding money is more expensive.

**Bridge to inflation.** Plant the seed: nominal rate is real rate + expected inflation (Fisher); expected inflation makes people want to hold less money unless  $M$  rises.

# Money demand shifts I: higher price level means higher *nominal* money demand

$M_t^d = P_t^1 m_t^d(r_t + \pi_{t+1}^e, Y_t)$

$M_t^d = P_t^0 m_t^d(r_t + \pi_{t+1}^e, Y_t)$

$r_t$

$r_t^0$

$M_t^{d,0}$      $M_t^{d,1}$

**Why this matters**

Because later, the price level  $P$  will be one of the key objects we want to understand.

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## Lecture 2: IS-LM

- Money market and LM
- Money demand shifts I: higher price level means higher *nominal* money demand

**Do a wallet thought experiment.** “If all prices double, how many dollars do you need in your pocket to buy lunch?”

**Main point.** Money demand is about *real* balances. A higher  $P$  shifts *nominal* money demand out.

**Transition.** “This is the first place  $P$  enters the model—through real balances  $M/P$ .”

**Money demand shifts I: higher price level means higher nominal money demand**

**Real balances are what matter for transactions:  $M/P$ .**

- If  $P$  rises, then to keep the same real balances you need **more nominal money**.
- So for given  $(Y, i)$ , the **nominal** money demand curve shifts outward.

**Why this matters**

Because later, the price level  $P$  will be one of the key objects we want to understand.

**Money demand shifts I: higher price level means higher nominal money demand**

$i^e$

$M_t^d = P_t^0 m_t^d(r_t + \pi_{t+1}^e, Y_t)$

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$M_t^{d,0}$      $M_t^{d,1}$

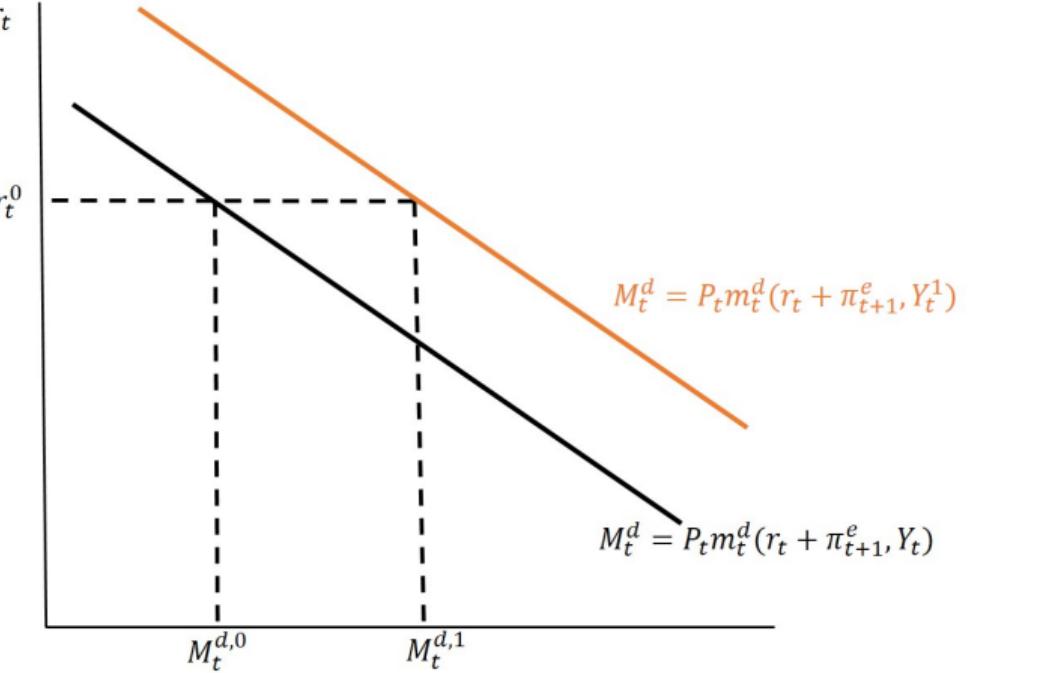
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## Money demand shifts II: higher income means more transactions



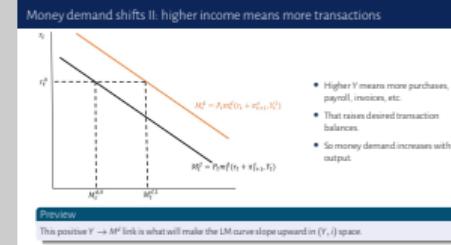
Preview

This positive  $Y \rightarrow M^d$  link is what will make the LM curve slope upward in  $(Y, i)$  space.

## Lecture 2: IS-LM └ Money market and LM

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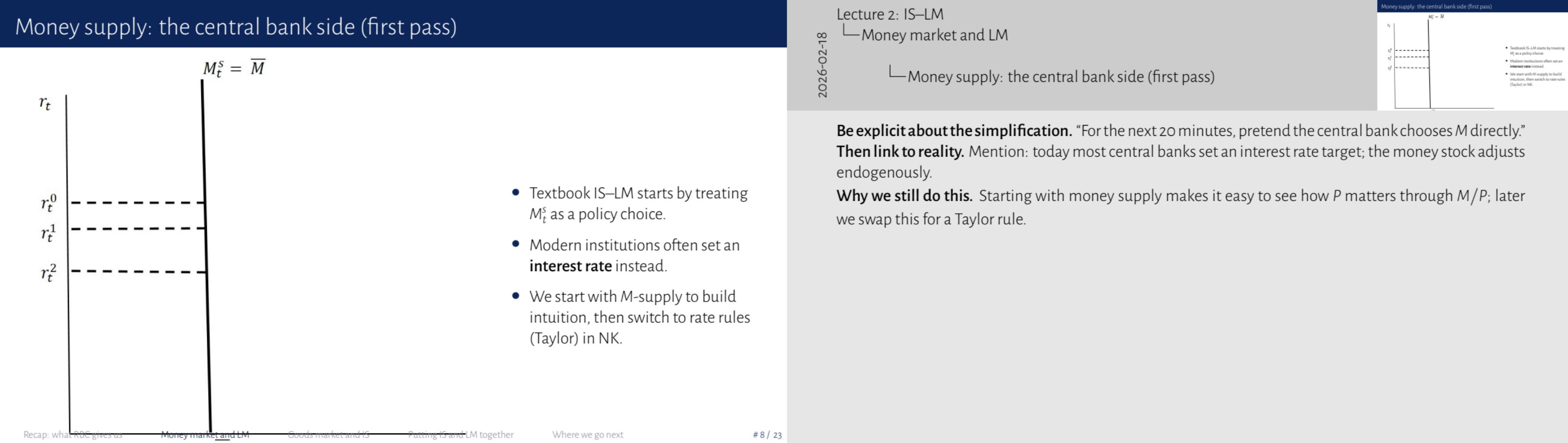
### └ Money demand shifts II: higher income means more transactions



**Scale effect.** Tie  $Y$  to transactions: more output/income means more purchases, so households/firms want to hold more cash-like balances.

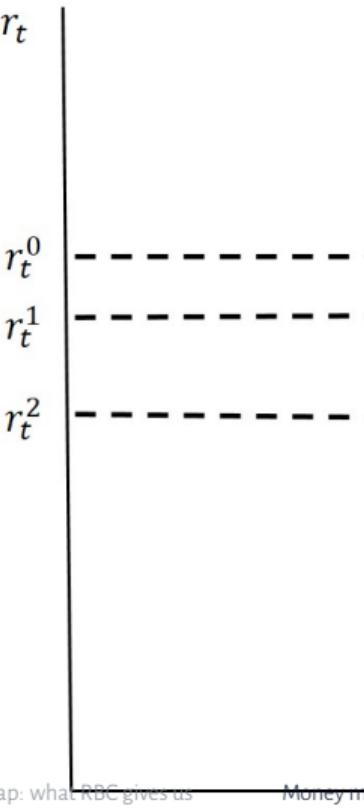
**Immediate implication.** Higher  $Y$  creates excess money demand at the old interest rate, so equilibrium requires a higher  $i$  (to reduce  $M^d$ ).

**Transition.** “Now let’s put money demand together with money supply to build LM.”



## Money supply: the central bank side (first pass)

$$M_t^s = \bar{M}$$



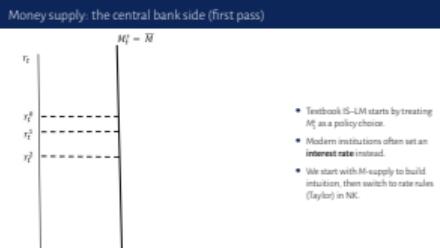
- Textbook IS–LM starts by treating  $M_t^s$  as a policy choice.
- Modern institutions often set an **interest rate** instead.
- We start with  $M$ -supply to build intuition, then switch to rate rules (Taylor) in NK.

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## Lecture 2: IS–LM

- └ Money market and LM

- └ Money supply: the central bank side (first pass)

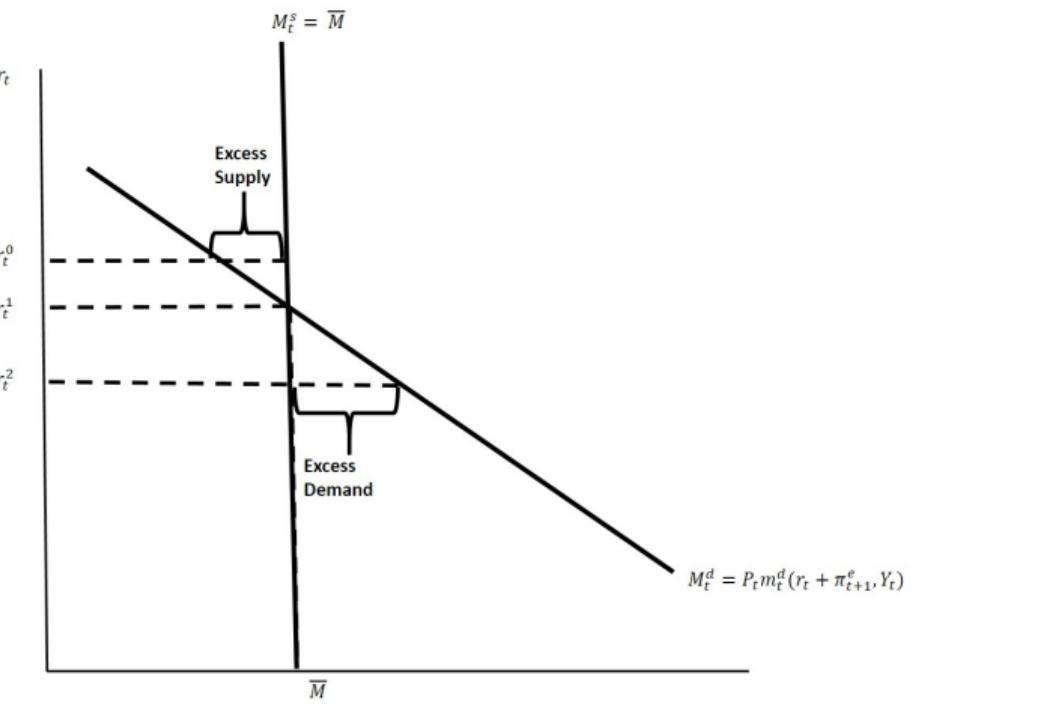


**Be explicit about the simplification.** “For the next 20 minutes, pretend the central bank chooses  $M$  directly.”

**Then link to reality.** Mention: today most central banks set an interest rate target; the money stock adjusts endogenously.

**Why we still do this.** Starting with money supply makes it easy to see how  $P$  matters through  $M/P$ ; later we swap this for a Taylor rule.

# Money market equilibrium: where $M^s = M^d$



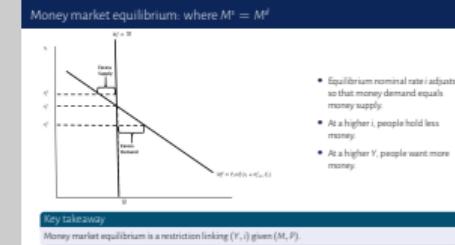
## Key takeaway

Money market equilibrium is a restriction linking  $(Y, i)$  given  $(M, P)$ .

## Lecture 2: IS-LM └ Money market and LM

### └ Money market equilibrium: where $M^s = M^d$

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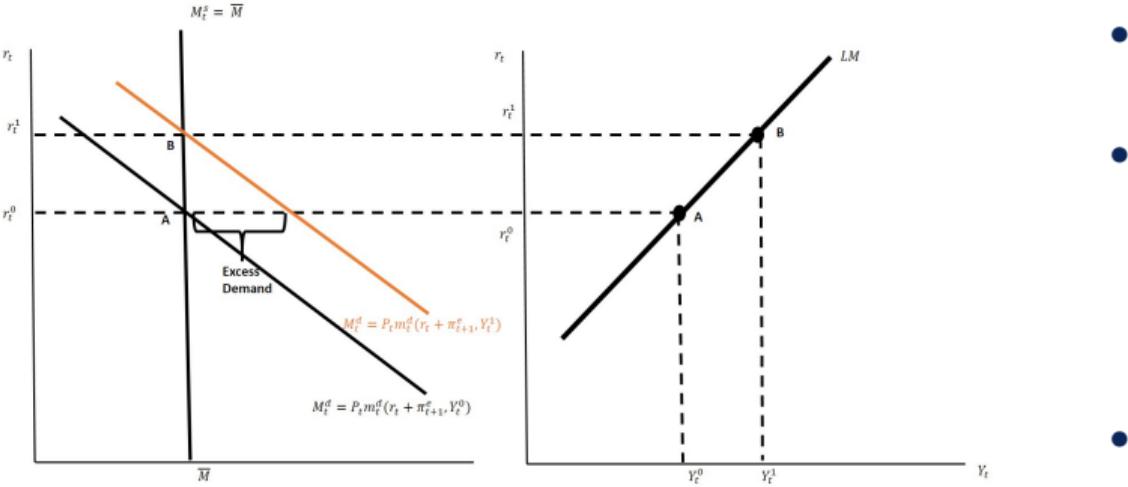


**Interpret the picture.** Stress: for a given  $Y$ , there is a unique  $i$  that clears the money market (given  $M$  and  $P$ ).

**Common confusion.** Students may think  $i$  is “set by the central bank” even here; clarify: in the money-supply version,  $i$  adjusts endogenously.

**Bridge line.** “Now let’s trace those equilibria as  $Y$  changes—that trace is the LM curve.”

# From money market equilibrium to the LM curve



LM equation (reduced form)

$$M_t^s = M_t^d = P_t \cdot m_t^d(Y_t, r_t + \pi_{t+1}^e).$$

## Lecture 2: IS-LM └ Money market and LM

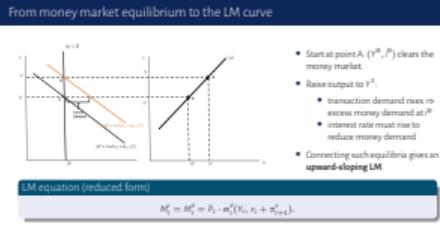
### └ From money market equilibrium to the LM curve

**Derivation story.** Narrate the step  $A \rightarrow$ higher  $Y \rightarrow$ excess money demand  $\rightarrow i$  must rise.

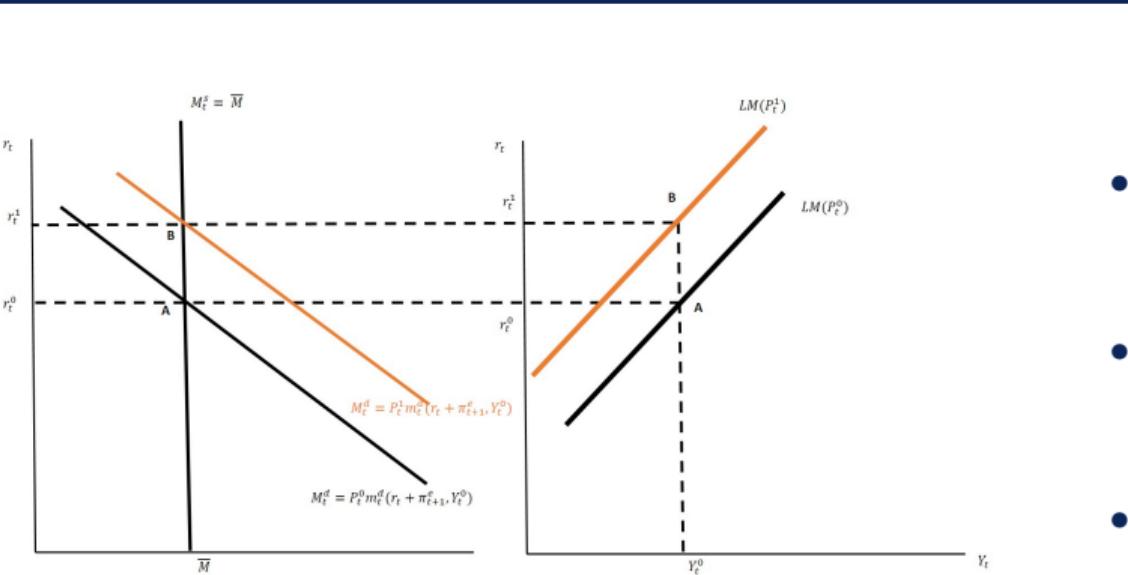
**Why upward sloping?** Because higher  $Y$  increases transactions and money demand.

**Notation discipline.** Tell students you will use  $i$  for nominal rate in this lecture; later you will separate  $i$ ,  $r$ , and expected inflation via Fisher.

**One-line summary.** LM is the set of  $(Y, i)$  pairs consistent with money market clearing for given  $M$  and  $P$ .



## How LM shifts I: higher $P$ shifts LM left



- If  $P$  rises, then at a given  $(Y, i)$  people need **more nominal money** to support the same real balances.
- With  $M^s$  fixed, equilibrium requires a **higher** interest rate (to discourage money holding).
- So the LM curve shifts **up/left**.

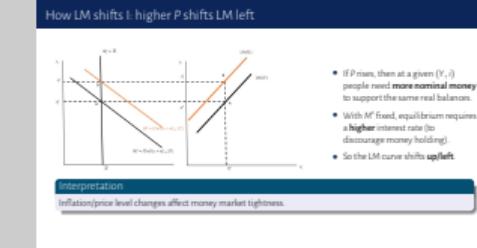
### Interpretation

Inflation/price level changes affect money market tightness.

## Lecture 2: IS-LM └ Money market and LM

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### └ How LM shifts I: higher $P$ shifts LM left



# How LM shifts II: higher $M^s$ shifts LM right

$M_t^s = \overline{M}_0$        $M_t^s = \overline{M}_1$

$r_t$

$r_t^0$        $r_t^1$

$M_t^d = P_t^0 m_t^d(r_t + \pi_{t+1}^e, V_t^0)$

$M_t^s = \overline{M}$

$r_t$

$r_t^0$        $r_t^1$

$Y_t^0$

$LM(\overline{M}_0)$        $LM(\overline{M}_1)$

Lecture 2: IS-LM  
└ Money market and LM

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└ How LM shifts II: higher  $M^s$  shifts LM right

**Interpretation.** More nominal money supply means the money market is “looser”: at the old  $i$  there is excess supply.

- Raise money supply (holding  $P$  fixed).
- At the old interest rate, there is excess money supply.
- The nominal rate falls until people are willing to hold the extra money.
- So LM shifts **down/right**.

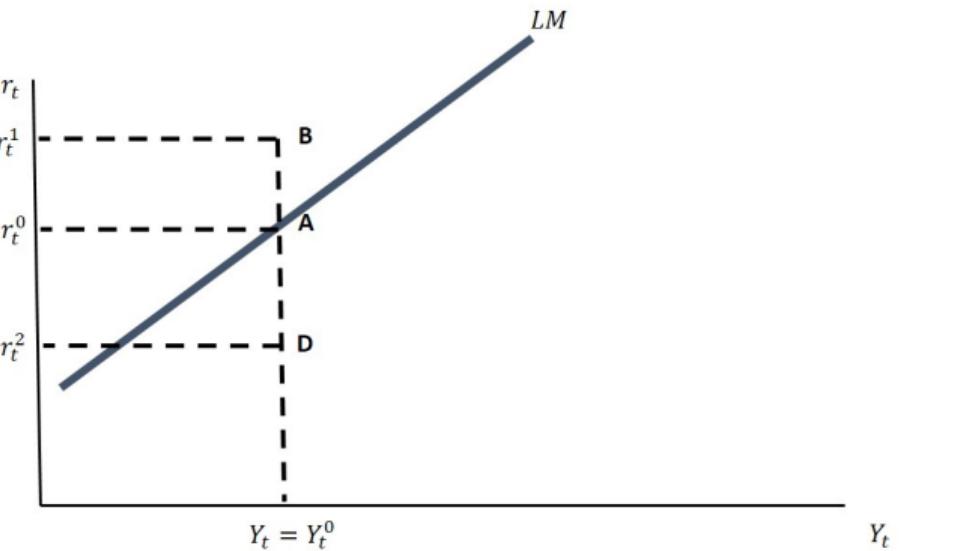
**Adjustment.** Interest rate must fall to raise money demand until it matches the higher supply.

**Connect to later.** Under an interest-rate target regime, this logic gets flipped: the central bank chooses  $i$ , and  $M$  adjusts.

How LM shifts II: higher  $M^s$  shifts LM right

- Raise money supply (holding  $P$  fixed).
- At the old interest rate, there is excess money supply.
- The nominal rate falls until people are willing to hold the extra money.
- So LM shifts **down/right**.

# What LM is (and is not): avoid a common confusion



- **On LM:** money market clears.
- **Off LM:** excess money demand or supply.
- LM does *not* mean “money market alone determines  $i$ .”
- It is one equilibrium condition inside a general equilibrium system.

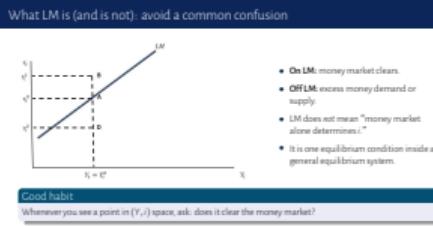
## Good habit

Whenever you see a point in  $(Y, i)$  space, ask: does it clear the money market?

## Lecture 2: IS–LM └ Money market and LM

### └ What LM is (and is not): avoid a common confusion

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**Pedagogical pause.** This slide prevents a common mistake: treating LM as “the central bank sets  $i$ ” or as a causal law.

**Explain on/off.** On LM:  $M^s = M^d$ . Above LM: excess money demand (people want more money than supplied) pushes  $i$  up. Below LM: excess supply pushes  $i$  down.

**Transition.** “We have one equilibrium condition (LM). Next, we need a second one (IS) to pin down a unique point’

# Goods market and IS

# IS: goods market equilibrium (bridge from RBC to textbook)

$Y_t = C(Y_t - T_t, i_t) + I(i_t) + G_t$

- In RBC, the intertemporal Euler equation is the foundation.
- IS-LM uses a reduced-form but keeps the same comparative statics:

$$Y_t = C(Y_t - T_t, i_t) + I(i_t) + G_t.$$

- Lower interest rates stimulate spending (especially investment)  $\Rightarrow$  higher goods demand.

## Interpretation

IS is a schedule of  $(Y, i)$  pairs where the **goods market clears**.

## Lecture 2: IS-LM

### └ Goods market and IS

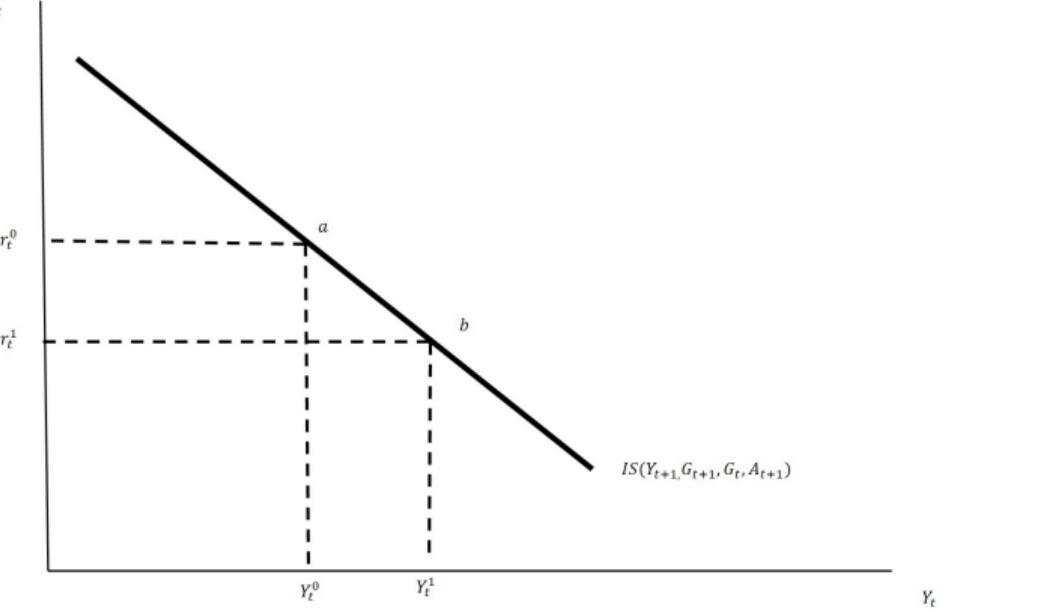
#### └ IS: goods market equilibrium (bridge from RBC to textbook)

**Bridge from RBC.** Say: “IS is a shortcut for the Euler equation + investment condition + market clearing.”

**Key mechanism.** Lower  $i$  encourages current spending (especially  $I$ ), so equilibrium output must rise.

**Clarify  $i$  vs  $r$ .** At this stage, treat  $i$  as “the relevant interest rate for spending.” Later, we will separate real vs nominal via Fisher.

## IS curve (visual): why it slopes downward



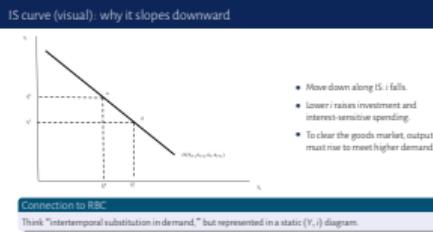
### Connection to RBC

Think “intertemporal substitution in demand,” but represented in a static ( $Y, i$ ) diagram.

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### └ IS curve (visual): why it slopes downward



**Read the diagram slowly.** Move from  $i_0$  to  $i_1 < i_0$ : demand rises; to restore goods-market clearing,  $Y$  must rise.

**Interpretation.** IS is a locus of equilibria, not a single behavioral equation by itself.

**Connect back to RBC.** Remind them: in RBC we solved a forward-looking system; IS–LM compresses that into a reduced-form demand schedule.

# Shifts in IS: what moves goods demand

- **Fiscal expansion** ( $G \uparrow$  or taxes  $\downarrow$ ) shifts IS right.
- **Optimism / higher expected income** shifts IS right (consumption rises today).
- **Higher uncertainty / tighter credit** shifts IS left (spending falls).

## What IS is not

IS is not “Keynesian by assumption.” It is a **reduced-form representation** of intertemporal demand that we will later microfound (NK IS / Euler equation).

## Lecture 2: IS–LM └ Goods market and IS

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### └ Shifts in IS: what moves goods demand

**Make a taxonomy.** Separate “shifts” from “moves along”: shocks to autonomous spending shift IS; changes in  $i$  move along IS.

**Interpret each bullet.**  $G \uparrow$  is a direct spending injection; optimism raises desired  $C$  today; uncertainty/credit tightness lowers desired  $I$  and  $C$ .

**Forward link.** Tell them: in NK, the IS curve becomes an Euler equation with expectations of future output and interest rates.

Shifts in IS: what moves goods demand

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# Putting IS and LM together

# IS-LM equilibrium: one point that clears two markets

• IS: goods market clearing  $\Rightarrow$  a relation between  $(Y, i)$ .  
• LM: money market clearing  $\Rightarrow$  another relation between  $(Y, i)$ .  
• Their intersection gives  $(Y, i)$  consistent with both markets.

## Why this is the “bridge model”

RBC emphasized **real** equilibrium. IS-LM adds a **money market** so we can start talking about nominal rates and (soon) the price level.

## Lecture 2: IS-LM

### └ Putting IS and LM together

### └ IS-LM equilibrium: one point that clears two markets

**One-line recap.** “IS tells us what  $(Y, i)$  combinations make spending match production; LM tells us what combinations clear the money market.”

**Classroom check.** Ask: “If output rises, which curve tells you what happens to the interest rate?” (LM, holding  $M, P$  fixed).

**Bridge sentence.** “Now that we have a place for  $P$  (through real balances), we can derive AD.”

IS-LM equilibrium: one point that clears two markets

• IS: goods market clearing  $\Rightarrow$  a relation between  $(Y, i)$ .

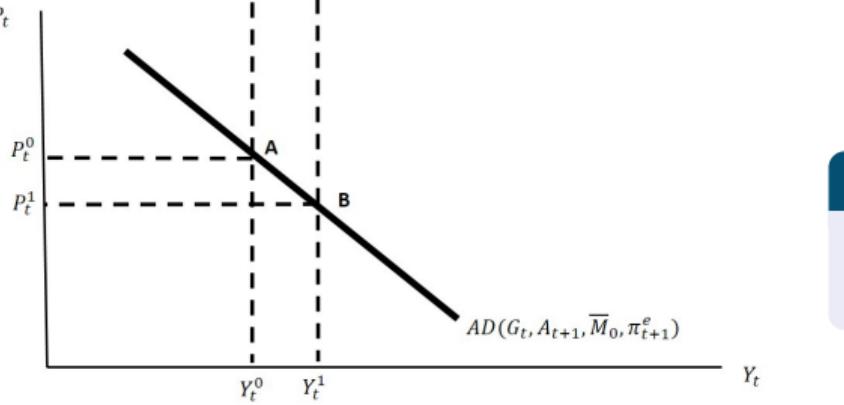
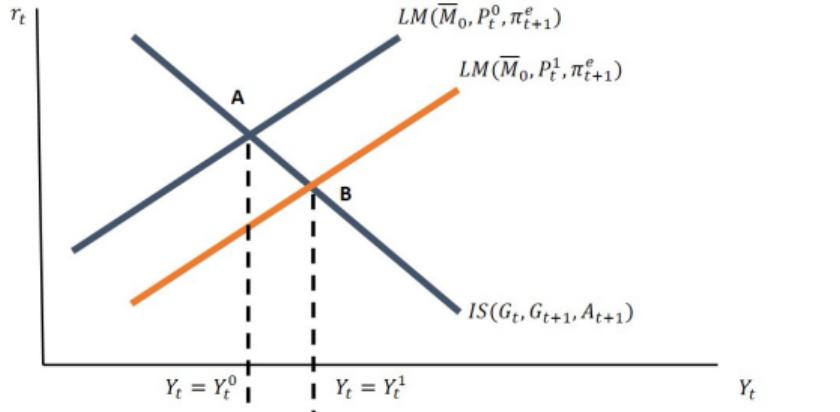
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Why this is the “bridge model”

RBC emphasized **real** equilibrium. IS-LM adds a **money market** so we can start talking about nominal rates and (soon) the price level.

# From IS–LM to Aggregate Demand: why AD slopes down



- Hold  $M$  fixed and lower  $P$ :

- real balances  $M/P$  rise
- money market becomes “looser”  $\Rightarrow$  LM shifts right

- New IS–LM intersection has higher  $Y$ .

- Therefore: lower  $P$  corresponds to higher  $Y \Rightarrow$  AD slopes down.

## Takeaway

Even before NK, IS–LM delivers a clean logic for a downward-sloping AD curve.

## Lecture 2: IS–LM

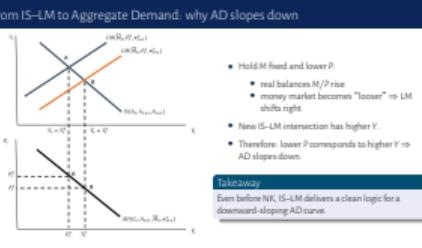
### Putting IS and LM together

#### From IS–LM to Aggregate Demand: why AD slopes down

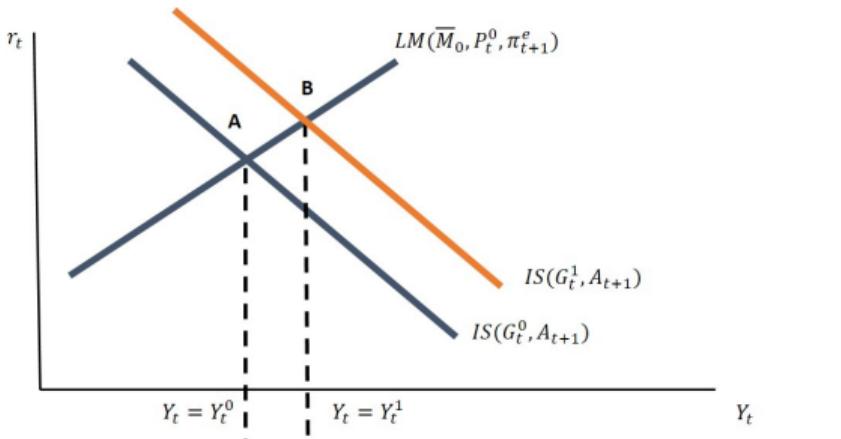
**Do it as a 4-step chain on the board.**  $P \downarrow \Rightarrow (M/P) \uparrow \Rightarrow$  LM right/down  $\Rightarrow i \downarrow$  and  $Y \uparrow$  at IS intersection.

**Emphasize what AD is.** It is the mapping from  $P$  to equilibrium  $Y$  holding policy instruments fixed (here:  $M$ ).

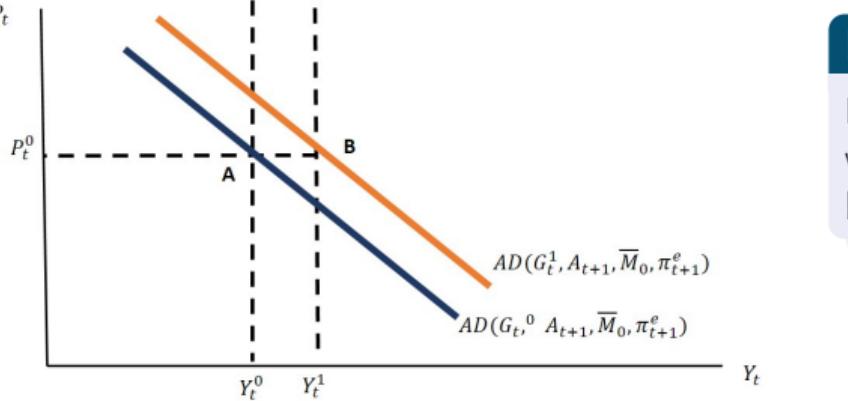
**Set up next lecture.** “AD alone does not tell us inflation. For that we need AS.”



# Policy experiment I: fiscal expansion shifts AD right



- $G \uparrow$  shifts IS right.
- For a given price level  $P$ , equilibrium output rises.
- In  $(P, Y)$  space: AD shifts right.



## Language students should learn

Fiscal policy raises demand; how much it raises *output* versus *prices* depends on the supply side (next lectures).

## Lecture 2: IS-LM

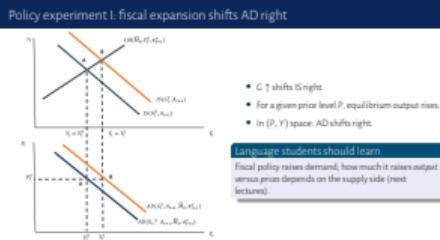
└ Putting IS and LM together

└ Policy experiment I: fiscal expansion shifts AD right

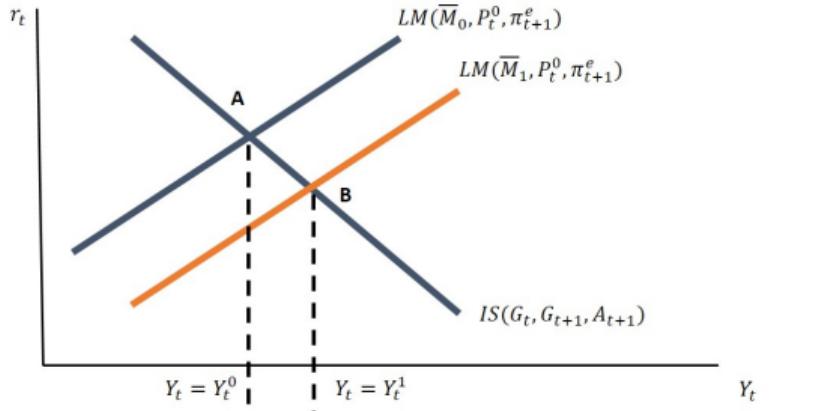
**Translate the diagram into words.** Fiscal expansion shifts IS right; for each  $P$ , equilibrium  $Y$  rises. That is an AD shift.

**Important warning.** This does not mean output rises one-for-one: the final split between  $Y$  and  $P$  depends on supply/price adjustment.

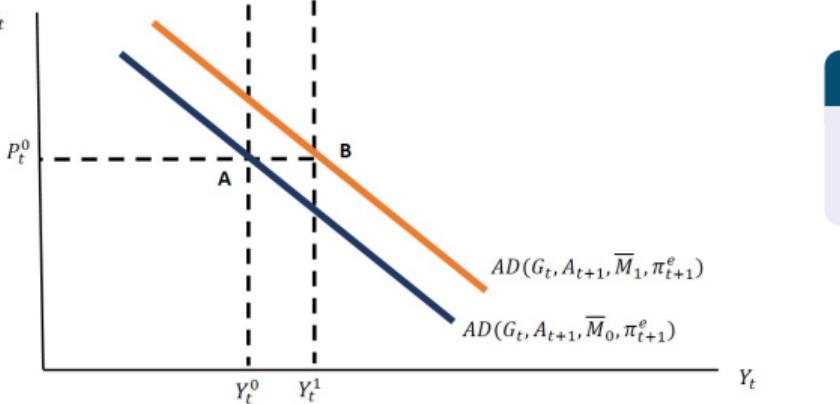
**Bridge to inflation course.** “This is where inflation enters: if AS is steep or expectations move, more of the adjustment shows up in prices.”



## Policy experiment II: monetary expansion shifts AD right



- $M^s \uparrow$  shifts LM right.
- For a given price level  $P$ , equilibrium output rises.
- In  $(P, Y)$  space: AD shifts right.



But modern central banks...

...often move  $i$  directly rather than  $M$ . This is why we will transition to **Taylor rules** and the NK model.

## Lecture 2: IS-LM

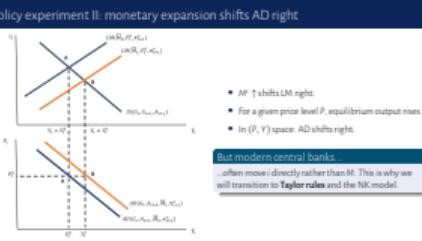
### Putting IS and LM together

#### Policy experiment II: monetary expansion shifts AD right

**Same logic, different tool.** In the money-supply version:  $M \uparrow$  shifts LM right. In modern practice: the central bank cuts  $i$  directly, which is like moving along a money-market condition.

**Preview Taylor rule.** Tell them: NK replaces LM with  $i_t = \phi_\pi \pi_t + \phi_y y_t + \dots$ , giving a different “anchor” story.

**Connect to 2021–22 motivation.** This is why the timing of rate moves matters in interpreting inflation episodes.



# Where we go next

# Why IS–LM is useful (and why we won't stop here)

- **Useful:** great for quick comparative statics and building intuition.
- **Limitations:**
  - Inflation expectations and credibility are awkward.
  - Central banks target interest rates, not money supply.
  - Price setting is not microfounded (no Phillips curve discipline).

**Next step**  
Replace “LM + ad hoc IS” with the **New Keynesian triad**: NK IS (Euler), NK Phillips curve, Taylor rule.

Lecture 2: IS–LM  
└ Where we go next  
└ Why IS–LM is useful (and why we won't stop here)

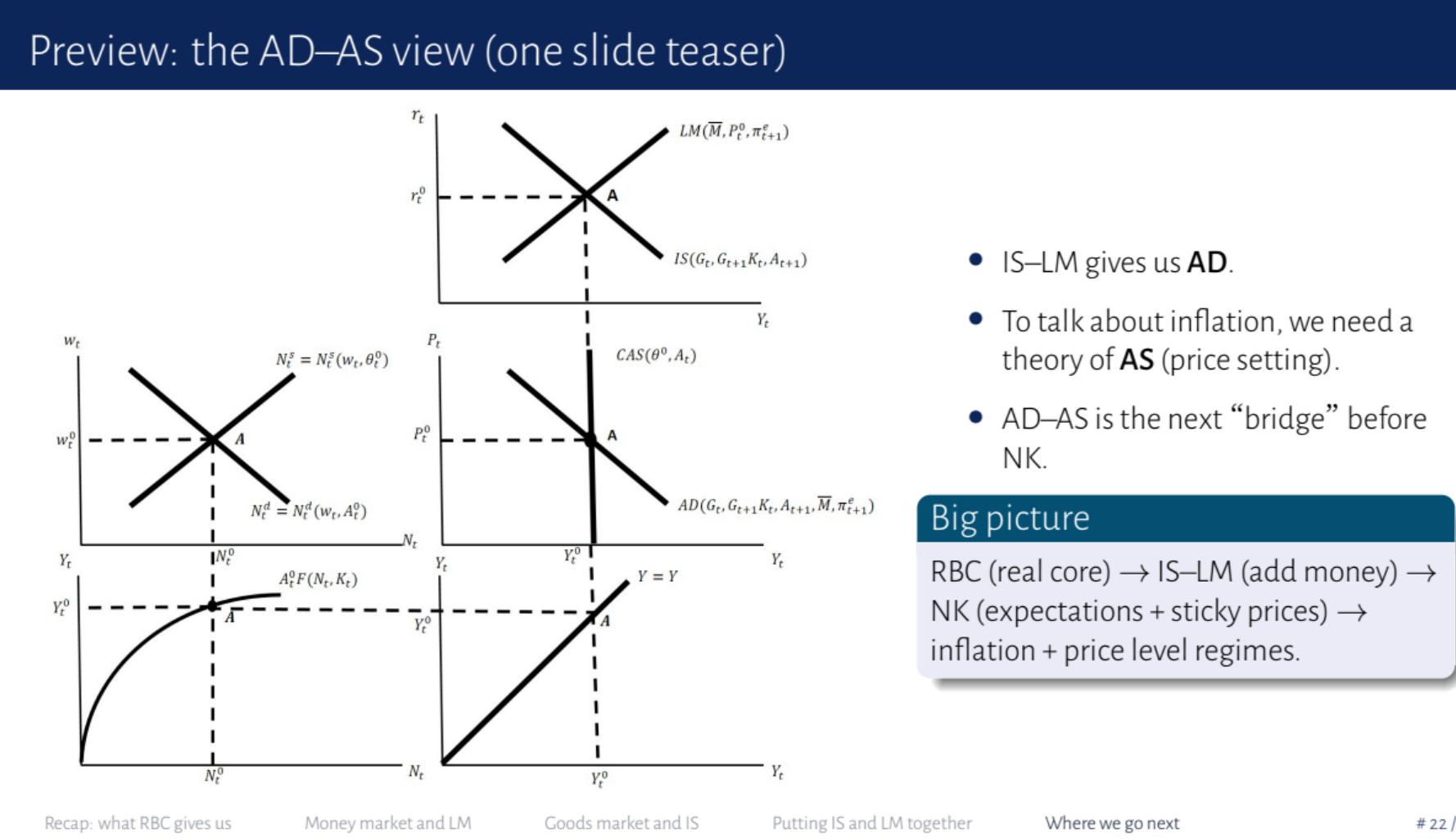
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**Be candid.** Students often ask “Is IS–LM true?” Answer: it is a useful reduced-form map; NK is the modern microfounded version.  
**Make the substitution explicit.** IS → Euler equation with expectations; LM → Taylor rule / monetary policy; AS → Phillips curve.  
**Motivation tie-in.** Mention: once we introduce expectations, we can talk about credibility, forward guidance, and disinflation without huge recessions.

Why IS–LM is useful (and why we won't stop here)

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## Lecture 2: IS–LM

### Where we go next

└ Preview: the AD–AS view (one slide teaser)

**Set expectations.** AD–AS is the next “language” before NK: it lets us discuss inflation/output tradeoffs cleanly.

**Explain AS qualitatively.** In the short run, sticky prices mean firms do not instantly adjust; that generates an AS relation between inflation and output (Phillips-curve-like).

**Link to your course goal.** “Our objective is to explain inflation episodes and the price level anchor; AD–AS and NK are the tools.”

**Preview: the AD–AS view (one slide teaser)**

• IS–LM gives us **AD**.  
 • To talk about inflation, we need a theory of **AS** (price setting).  
 • AD–AS is the next “bridge” before NK.

**Big picture**

RBC (real core) → IS–LM (add money) → NK (expectations + sticky prices) → inflation + price level regimes.

# Next time

- AD–AS: what moves inflation vs what moves output?
- Short run vs long run: when do we get “crowding out” versus “inflation” ?
- Then: New Keynesian model as the modern workhorse.

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## Lecture 2: IS–LM

- └ Where we go next
- └ Next time

Next time

- AD–AS: what moves inflation vs what moves output?
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Recap: what RBC gives us

Money market and LM

Goods market and IS

Putting IS and LM together

Where we go next

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