

Lawrence Summers' Response to Prescott's Article

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- The Fall 1986 issue of the Minneapolis Fed's *Quarterly Review* featured an article by article by Edward Prescott summarizing the real business cycle (RBC) research program.
- He argued that a stochastic neoclassical growth model could match empirical facts about the US business cycle.
- His framework has the appealing features that it is (relatively) simple and based on microeconomic principles.

- Prescott concludes on page 21 that:

Economic fluctuations are optimal responses to uncertainty in the rate of technological change.

and that the:

attention [of policymakers] should be focused not on fluctuations in output but rather on determinants of the average rate of technological advance.

- Both points were and are controversial to many macroeconomists

- The issue of the *Quarterly Review* in which Prescott's article appeared also featured a reaction by Lawrence Summers.
- Summers' article, "Some Skeptical Observations on Real Business Cycle Theory", presents sharp criticisms of RBC theory.

- In the opening of the article, Summers asserts that RBC theory is at odds with

propositions thought self-evident by many macroeconomist and all of those involved in forecasting and controlling the economy on a day-to-day basis.

- Summers provides four specific critiques of Prescott's framework

- Summary of Summers' critiques:
 - ① The parameterization that Prescott uses in the simulations are suspect.
 - ② Prescott doesn't provide supporting evidence for the existence of TFP shocks.
 - ③ Prescott doesn't explore whether his RBC model can match price (e.g., real wages, interest rates) data.
 - ④ Prescott's model completely disregards the large-scale market failures that accompany business cycle downturns (e.g., unemployment)

Summers' Response

- Summers claims that progress in macroeconomics depends on *the development of theories that can explain why exchange sometimes works well and other times breaks down.*
- And he concludes with:
Nothing could be more counterproductive in this regard than a lengthy professional detour into the analysis of stochastic Robinson Crusoes.
- In the first point he was prescient but in the last point he was greatly mistaken
- Contemporary business cycle models incorporate market failures into RBC-style models with great success.

- Prescott, Edward C.**, "Theory Ahead of Business Cycle Measurement," *Federal Reserve Bank of Minneapolis Quarterly Review*, Fall 1986, 10 (4), 9–22.
- Summers, Lawrence H.**, "Some Skeptical Observations on Real Business Cycle Theory," *Federal Reserve Bank of Minneapolis Quarterly Review*, Fall 1986, 10 (4), 23–27.