

# Lawrence Summers' Response to Prescott's Article

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# Introduction

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- 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.

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- Both points were and are controversial to many macroeconomists

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- Summers' article, "Some Skeptical Observations on Real Business Cycle Theory", presents sharp criticisms of RBC theory.

# Summers' Response

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*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

# Summers' Response

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  - 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)

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- 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.*

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- 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.