

Absence of Slack in Modern Business-Cycle Models

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Prevailing paradigm in business-cycle research today. New Keynesian paradigm

3 main issues w/ New Keynesian model

① Model is not economical.

- Too complicated to be included in intermediate macro textbooks
- Not used by policymakers for day-to-day thinking about macro issues (Krugman 2000, 2018)
- Complicated derivations, even in the simplest case (ask anybody who tries to teach it in first-year graduate macro)

② Model does not describe well economic shock

- Cannot describe large increases in unemployment in recessions (cannot describe or explain 10% unemployment in 2008 or 21% unemployment in 1932) → b/c there's no unemployment in my model
- Cannot describe sharp increases in idle capacity in firms in recessions → b/c firms use all the capacity (labor) they hire

③ Model makes anomalous predictions about long ZLB episodes

- Collapse of output / inflation
- Implausibly large effects of forward-

guidance policy

- Implausibly large effects of fiscal policy

In this course we develop a model of business cycle that tries to address these limitations

- ① Model features slack on all markets, including unemployment on the labor market
- ② Model is fairly simple, static, deterministic version with one market captures many insights of the framework. Many results can be obtained by comparative statics
- ③ Model behaves well at the ZLB →
does not have an explosive behavior. Model also features cyclical multipliers.