Lawrence Summers' Response to Prescott's Article

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November 9, 2022

Introduction

- 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.

Introduction

- 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

Summers' Response

- 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.

Summers' Response

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

  > *propositions thought self-evident by many macroeconomists 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

- 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.

References

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.