The Basic Problem

- Business Cycles Occur
  - People get upset about them.

The Basic Problem

- Business Cycles Occur
- A lot of time is spent discussing Business Cycles
  - Economists spend a lot of time discussing how to deal with them.
  - Politicians take a lot of time taking credit for good times and passing blame for bad times.

The Lucas View

\[ \log(c_t) \]

\[ t \]

The Lucas View

\[ \log(c_t) \]

\[ t \]
Business Cycles mean volatility in consumption and uncertainty costs

People hate uncertainty

Business cycles also mean volatility in employment

But how much is eliminating the uncertainty worth to you?

A Naïve View

The Choice

50% Chance C = $800
50% Chance C = $1200
or
C = $1000
The Choice

50% Chance C = $800
50% Chance C = $1200

or

C = $1000

A Formal Analysis

\[ E(U) = \frac{1}{2} \log(800) + \frac{1}{2} \log(1200) = 6.89 \]

or

\[ \log(1000) = 6.91 \]

The Real Choice

50% Chance C = $808
50% Chance C = $1212

or

C = $1000
What Business Cycles Cost Us
– Part 1

The Real Choice

50% Chance C = $800(1 + \lambda)
50% Chance C = $1200(1 + \lambda)
or
C = $1000

Suppose \lambda = 0.02. Then it would be worth giving up a 2% increase in uncertain consumption to eliminate the uncertainty.

C = $1000

The Real Choice

\lambda = 0.0205

Eliminating uncertainty would have the same benefit as a 2.05% increase in consumption.

\lambda \approx 0.015

The Numbers

\[ E(U) = \frac{1}{2} \log(800[1 + \lambda]) + \frac{1}{2} \log(1200[1 + \lambda]) = \log(1000) \]

The Numbers

\[ E(U) = \frac{1}{2} \log(800[1 + \lambda]) + \frac{1}{2} \log(1200[1 + \lambda]) = \log(1000) \]

The Answer
The Answer

\[ \lambda \approx 0.015 \]

Eliminating business cycles is worth as much as a 1.5% increase in consumption.

Since \( C \) runs about $7,000 billion per year, this is equal to about $105 billion per year.

End

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