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2 Mavericks in Economics Awarded Nobel Prize

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An American and a Norwegian economist were awarded the Nobel in economics yesterday for their efforts to demonstrate that innovative technologies and shocks, like a sharp increase in oil prices, play a much greater role in causing booms and recessions than fluctuations in demand.

The $1.3 million Nobel Memorial Prize in Economic Science went to Edward C. Prescott, 63, and Finn E. Kydland, 60, for two papers they wrote between 1977 and 1982. Their findings contradicted Keynesian theory, which held that changes in demand, particularly consumer demand, played the greatest role in business cycles. The Prescott-Kydland papers "transformed academic research in economics" and also transformed policy making, the Royal Swedish Academy of Sciences said in its citation.

Their first paper, which appeared when both were at Carnegie Mellon University in Pittsburgh, argued in effect that government officials should adhere to rules rather than resort to short-term policy shifts when circumstances change. If holding down inflation is the Federal Reserve's goal, for example, then the Fed should refrain from sharp cuts in interest rates during hard times, an approach that might result in too much stimulus and too much inflation later on. Better to resist changes in policy and suffer through some hardship if minimizing inflation makes people better off in the long run, their thesis maintained.

The two economists developed their second paper in the summer of 1980. Mr. Kydland had returned temporarily to his undergraduate alma mater, the Norwegian School of Economics and Business Administration in Bergen, and Mr. Prescott had gone there as a visiting professor with his wife and three children. Out of that collaboration came the view that supply shocks or new technology produce booms and busts, not changes in demand.

The two economists, and Mr. Prescott in particular, "got people to think more broadly about what influences the economy over time," said Gary Stern, president of the Federal Reserve Bank of Minneapolis.

Mr. Prescott divides his time between a teaching post at Arizona State University and a staff job at the Federal Reserve Bank of Minneapolis, making him the first Nobel laureate employed by the Fed. From 1980 through 2003, he had served as an adviser to the Minneapolis bank while holding a regular job as a professor of economics at the University of Minnesota.

Mr. Kydland has taught almost continuously at Carnegie Mellon since 1978, but is on leave this academic year at the University of California, Santa Barbara.

There was one catch in their work that has riled a faction of the economics profession. The Prescott-Kydland finding assumed that demand was always at a high level. Everyone who wanted to work did so at the prevailing wage and all production could be sold at the existing market price. Supply, in effect, created its own demand. Thus, they posited, changes to the economy came not from fluctuations in demand, but from shocks.

The oil embargo that caused sharply higher prices and the 9/11 terrorism would be negative shocks, while the Internet and high-speed computers would have a positive impact, increasing productivity and growth. The negative supply shocks, and not policy, cut into consumer spending and job creation.

"Everyone thought that monetary policy shocks - sharp changes in interest rates - made economic growth fluctuate," Mr. Prescott said in a telephone interview yesterday. "We found, to our surprise, that persistent changes in real factors gave rise to fluctuations in the business cycle."
That thesis in the second paper was controversial because it went directly against the worldview of John Maynard Keynes, the famed British economist who held that the Depression was a result of weaker employment and weaker demand for the goods and services than the nation was capable of producing.

To make supply and demand balance each other at a high level, policy makers had to step in with sharply lower interest rates or increased public spending or well-aimed tax cuts, or some combination of the three.

That is still a strongly held view among some economists who criticized the Nobel award to Mr. Prescott and Mr. Kydland. "I am not alone in feeling that the Kydland-Prescott model of business cycles was a significant step backward," said Robert Gordon, an economist at Northwestern University.

The second paper was published at a time when Keynesian theory was in retreat, partly as a result of the stagflation, or rising inflation despite a weak economy, that appeared in the 1970s. Some economists argue that the Prescott-Kydland paper, rather than rule out demand as a cause of business cycle fluctuation, simply added supply shocks as an additional cause.

"What they did was layer supply shocks into the description of how the business cycle worked," said Achuthan Lakshman, managing director of the Economic Cycle Research Institute.

Mr. Gordon argued yesterday that numerous economists had already achieved this integration and the Prescott-Kydland paper followed in their footsteps, with the additional questionable thesis that demand is always optimal.

Mr. Prescott was asleep at his new home in Tempe, Ariz., when the call about the award came from Sweden.

"An important person on the Nobel committee gave me the news at 4 a.m.," Mr. Prescott said. He had just returned from a family wedding in San Francisco. His wife had stayed behind and he called her there before dawn. He also tried to reach Mr. Kydland at the university in Santa Barbara.

Mr. Prescott said he left a message on an answering machine, not knowing that Mr. Kydland was in Norway giving a guest lecture at his alma mater. In the middle of the lecture, Mr. Kydland was told there was a call from Stockholm and he broke off to take it, Reuters reported.

Mr. Kydland and Mr. Prescott began their collaboration at Carnegie Mellon while Mr. Kydland was studying for his Ph.D. and Mr. Prescott was his thesis adviser. "There were not many graduate students at Carnegie Mellon and they were like colleagues," Mr. Prescott said.

The first paper cited in the Nobel award, titled "Rules Rather than Discretion: The Inconsistency of Optimal Plans," is considered by many economists to be a valid and innovative framework for considering public policy over a wide range - not only Fed interest rate policy but policies on such matters as building homes on flood plains.

If houses go up in such high-risk areas and a flood destroys them, policy makers are faced with the question of whether to provide aid to help the victims rebuild or to let them bear the financial burden of rebuilding. Prescott-Kydland would say it is best not to provide aid, because in the long run it is better if homes are not constructed on flood plains where there is a risk of their being destroyed. While the government typically extends aid, of course, the Prescott-Kydland perspective is a useful tool for examining such policy issues, says Alan Blinder, a Princeton University economist.

"One of the hallmarks of a great intellectual achievement is that it brings into a common framework a wide variety of seemingly different problems," Mr. Blinder said.