

THE PLUCKING MODEL, THE GREAT RECESSION, AND AUSTRIAN BUSINESS CYCLE THEORY

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ABSTRACT: This brief note points out that Milton Friedman’s “Plucking Model” has not held following the Great Recession. Friedman argued that the Plucking Model offered evidence against theories like Austrian Business Cycle theory; the bust was what needed explanation, not the boom. But as many economists have pointed out, the years leading up to the Great Recession fit many of the stylized predictions of the Austrian Business Cycle. Given their observations, it is of interest that the bust in recent years has not followed the Plucking Model.

KEYWORDS: Austrian Business Cycle, Plucking Model, Great Recession

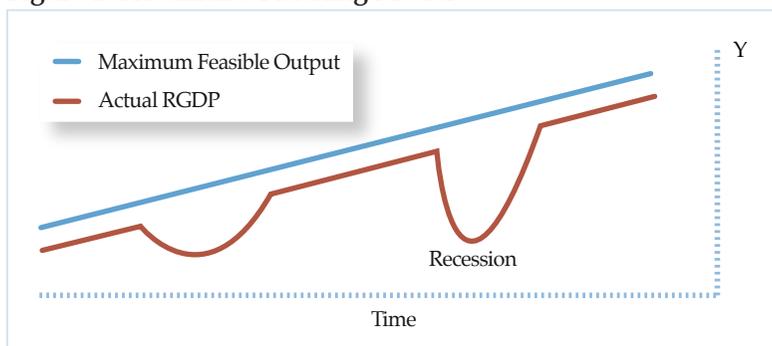
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Milton Friedman’s “Plucking Model” (Friedman, 1993) has been used to argue against the relevance of theories of the “boom” preceding economic downturns, such as Austrian Business Cycle Theory (ABCT). According to Friedman, output data show that economies follow a trend, with recessions being temporary setbacks prior to a return to a trend approaching the economy’s maximum

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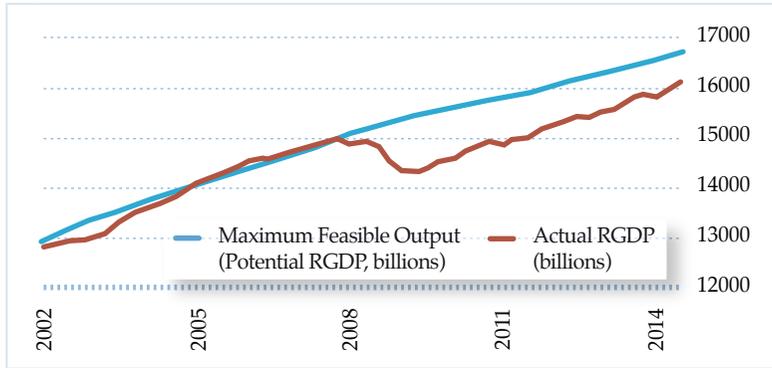
feasible output. Economies do not substantially go over trend during a boom; they collapse and then return to trend. Recessions “pluck” output downwards, but booms do not have similar effects in the opposite direction, as shown in Figure 1. Therefore, busts are what is to be explained, not the boom. While defenders of ABCT have objected to this interpretation (e.g. Garrison 1996), it remains an effective rhetorical point among macroeconomists.

Figure 1. Friedman’s Plucking Model



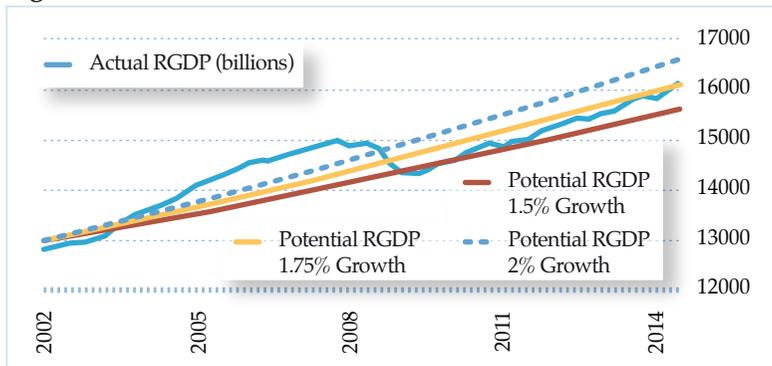
However, despite the unemployment rate in the United States falling to 5.8 percent as of October 2014 following the Great Recession, RGDP has not returned to its “potential,” i.e., Friedman’s maximum feasible output. This contradicts the historical record which Friedman highlighted as fatal for ABCT. Figure 2 provides actual and potential RGDP in the United States since 2002 (data from FRED). From 2008–2009, RGDP fell off significantly in comparison to its potential, and while it has grown since then, it did not snap back to potential as predicted by the plucking model.

Figure 2. Actual RGDP Versus Official Potential RGDP



These data for potential RGDP assume that the economy was not overheating during the boom. If we grant the possibility that an ABCT boom was happening in the middle of the first decade of the millennium, then an altogether different picture emerges. Figure 3 compares actual RGDP against the assumptions that potential RGDP increased 1.5 percent, 1.75 percent, and 2 percent per year, starting in 2002. Under any of those assumptions (especially the middle case), the boom is clear and the modest growth rates we experience now are merely reflective of what is possible today given the US economy’s fundamentals.

Figure 3. Actual RGDP Versus Alternative Potential RGDPs



In the context of the plucking model, recent data do not reject ABCT. If anything, the data behave exactly as ABCT predicts—or at least how Friedman conceived of ABCT predicting. The reason for the importance of this point is the revival of interest in ABCT from mainstream economists, as documented by Cachanosky and Salter (2013). These mainstream economists, including Caballero (2010), Diamond and Rajan (2009), and Taylor (2009) each have made the argument that, of all recessions of recent memory, the Great Recession most clearly fit the stylized predictions of ABCT.

If these economists were correct, that this recession was a departure from the patterns of others, then it stands to reason that economies would cease behaving in accordance to the plucking model, which is precisely what has happened. This is not in any way the “Texas sharpshooter fallacy,” where after the fact the “test” of a theory is defined so that the theory passes; the plucking model has been one of the primary rationales as to why ABCT was dismissed by macroeconomists.

It may be a coincidence that the first time in nearly a century mainstream economists recognized how well the stylized predictions of ABCT fit a recession was also the first time in recent memory that the plucking model failed to hold. Perhaps in the coming years the US will experience rapid growth, and the pluck of the Great Recession was just a very large, slow pluck. Or it is perhaps the case that the Great Recession is the clearest example of an Austrian Business Cycle we have on record, and the data bear that out.

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