

DEPARTMENT OF ECONOMICS

Faculty of Social Sciences



Seminar on Economics No. 185



Understanding Business Cycles: A Perspective from Stablizing and Destablizing Mechanism



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Abstract

We study economic fluctuation and business cycles from a perspective of stabilizing and destabilizing mechanisms. While price adjustment can be regarded as a stabilizing mechanism, are there mechanisms that destabilize an economy? We find that as early as in 1939, Harrod discussed a destabilizing mechanism---the firm's adjustment of its investment---illustrated in his knife-edge puzzle. We construct a macro-dynamic model with investment and price as the core macroeconomic variables. Our analysis shows that the interaction between the stabilizing mechanism (price adjustment) and the destabilizing mechanism (investment adjustment) generates fluctuations and cycles. Yet, due to the stickiness in its adjustment, pricing may not be sufficient to stabilize the economy. In this case, the government stabilization policy is needed to provide further stabilization.