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Beautiful Cycles: A Theory and a Model Implying a Curious Role for Interest

by Marco Gross

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Beautiful Cycles: A Theory and a Model Implying a Curious Role for Interest *

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Abstract

Where do economic cycles come from? This paper contemplates an utmost minimalistic model and underlying theory that rest on two assumptions for letting them emerge endogenously: (1) the presence of interest-bearing debt; and (2) a degree of downward nominal wage rigidity. Despite its parsimony, the model generates well-behaved, self-evolving limit cycles and replicates six essential empirical facts: (1) booms are long- while recessions short-lived; (2) leverage is procyclical; (3) firm profit and wage shares in GDP are counter- and procyclical, respectively; (4) Phillips curves are downward-sloping and convex, and Okun's law relation is replicated; (5) default cascades arise endogenously at the turning points to recessions; (6) lending spreads are countercyclical. One can refer to the model as being of a Dynamic Stochastic General Disequilibrium (DSGD) kind.

JEL Classification: E20, E30, E40, E51, P10.

Keywords: Business and financial cycles.

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