# Learning Journal 7

# Real-Business-Cycle (RBC) Theory and Economic Fluctuations

The Real-Business-Cycle (RBC) theory posits that economic fluctuations primarily result from real shocks, particularly those related to technology and productivity, rather than monetary or demand-side disturbances. According to this view, business cycles are not deviations from a stable trend due to market failure, but rather the natural and optimal response of rational agents to real changes in the economic environment (Plosser, 1989). For instance, a technological innovation that enhances production efficiency leads to economic expansion, whereas a negative productivity shock results in contraction. These fluctuations are considered efficient and self-correcting, driven by shifts in the productive capacity of the economy.

Another key assumption of RBC theory is that economic agents—households and firms—are rational and forward-looking. Households make labor-leisure and consumption-saving decisions based on intertemporal preferences, while firms choose investment and output levels to maximize expected profits. These decisions are made under the assumption of full information and efficient markets (Kydland & Prescott, 1982). Business cycles, in this context, reflect optimal adjustments to external shocks rather than policy failures or demand shortfalls. Consequently, RBC theorists argue that macroeconomic policy interventions are generally unnecessary and may even distort the economy's natural adjustment process.

RBC models also assume that markets are perfectly competitive and that prices and wages adjust rapidly to clear all markets. As a result, the economy is seen as always operating at its potential output, and unemployment is largely voluntary or frictional rather than cyclical (King & Rebelo, 1999). This sharply contrasts with Keynesian perspectives that emphasize sticky wages and prices, leading to involuntary unemployment and the need for active policy responses. While RBC theory has been influential in advancing dynamic and micro-founded models of the macroeconomy, it has been critiqued for downplaying the role of monetary factors, demand-side shocks, and institutional frictions in explaining real-world economic fluctuations.

# References

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