INTRODUCTION TO ECONOMICS

LEARNING JOURNAL UNIT 7

ECON 1580-01 INTRODUCTION TO ECONOMICS - AY2024-T3

MARCH 20, 2024

INSTRUCTOR: CHRISTOPHER STUTTS

ECONOMISTS CLASH OVER UNCONVENTIONAL BUSINESS CYCLE THEORY

INTRODUCTION

Economists Finn Kydland and Edward Prescott pioneered the Real-Business-Cycle (RBC) Theory that offers an unconventional explanation for economic ups and downs. While traditional Keynesian models attribute recessions to insufficient aggregate demand, the RBC Theory proposes economic fluctuations naturally emerge from the economy's efficient response to real shocks (Plosser, 1989). This contrasting view sparked heated debates among economists.

TECHNOLOGY DRIVING FORCE

A central notion of the RBC Theory states fluctuations in total factor productivity (TFP) – the overall input-to-output efficiency – drive business cycles. Proponents argue positive technological shocks boost productivity fueling economic booms while negative shocks diminish productivity causing recessions (Prescott, 1982). The theory considers these shocks from innovations, policy changes, or other factors as the "impulses" generating business cycles.

RATIONAL AGENTS AND EQUILIBRIUM

RBC models assume economic agents like households and firms act rationally making optimal forward-looking decisions based on future expectations (Rebelo, 2005). Under this framework recessions result not from market failures or irrationality but from the efficient response by rational agents to productivity changes. The economy remains in equilibrium with prices and quantities adjusting optimally to real shocks.

IMPLICATIONS AND CRITICISMS

A key RBC Theory implication suggests government intervention aiming to stabilize the economy may counterproductively distort efficient resource allocation. However, critics argue the theory fails to explain observable economic data patterns like sluggish employment responses to shocks and the importance of monetary factors driving business cycles (Galı, 1999). Some also question the plausibility of large frequent productivity shocks required to generate observed fluctuations.

CONCLUSION

Despite its controversial nature the Real-Business-Cycle Theory contributed to understanding economic fluctuations and influenced the development of modern macroeconomic models. Regardless of agreement with its assumptions the RBC Theory challenged traditional Keynesian views prompting important debates about the roles of technology, rationality, and equilibrium in explaining business cycles.

Wordcount: 302

REFERENCES:

Galı, J. (1999). Technology, employment, and the business cycle: Do technology shocks explain aggregate fluctuations? The American Economic Review, 89(1), 249–271. https://doi.org/10.1257/aer.89.1.249

Prescott, E. C, Kydland, F. E. (1982). Time to build and aggregate fluctuations. Econometrica, 50(6), 1345–1370. https://doi.org/10.2307/1913386. https://www.jstor.org/stable/1913386

Plosser, C. I. (1989). Understanding Real Business Cycles. Journal of Economic Perspectives. https://www.sfu.ca/~kkasa/plosser.pdf

Rebelo, S. (2005). Real Business cycle models: past, present and future. The Scandinavian Journal of Economics, 107(2), 217–238. https://www.jstor.org/stable/3441103