SOME SKEPTICAL OBSERVATIONS ON REAL BUSINESS CYCLE THEORY

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CONTEXT

- This paper is about the Summers' critique on Real Business Cycle (RBC) theory developed by Prescott's paper "Theory Ahead of Business Cycle Measurement".
- RBC: Monetary policies have no effect on real activity, fiscal policies influence the economy only through their incentive effects, and economic fluctuations are caused entirely by supply rather than demand shocks.
- Summers' view is that real business cycle models by Prescott have nothing to do with the business cycle phenomena observed in the United States or other capitalist economies.

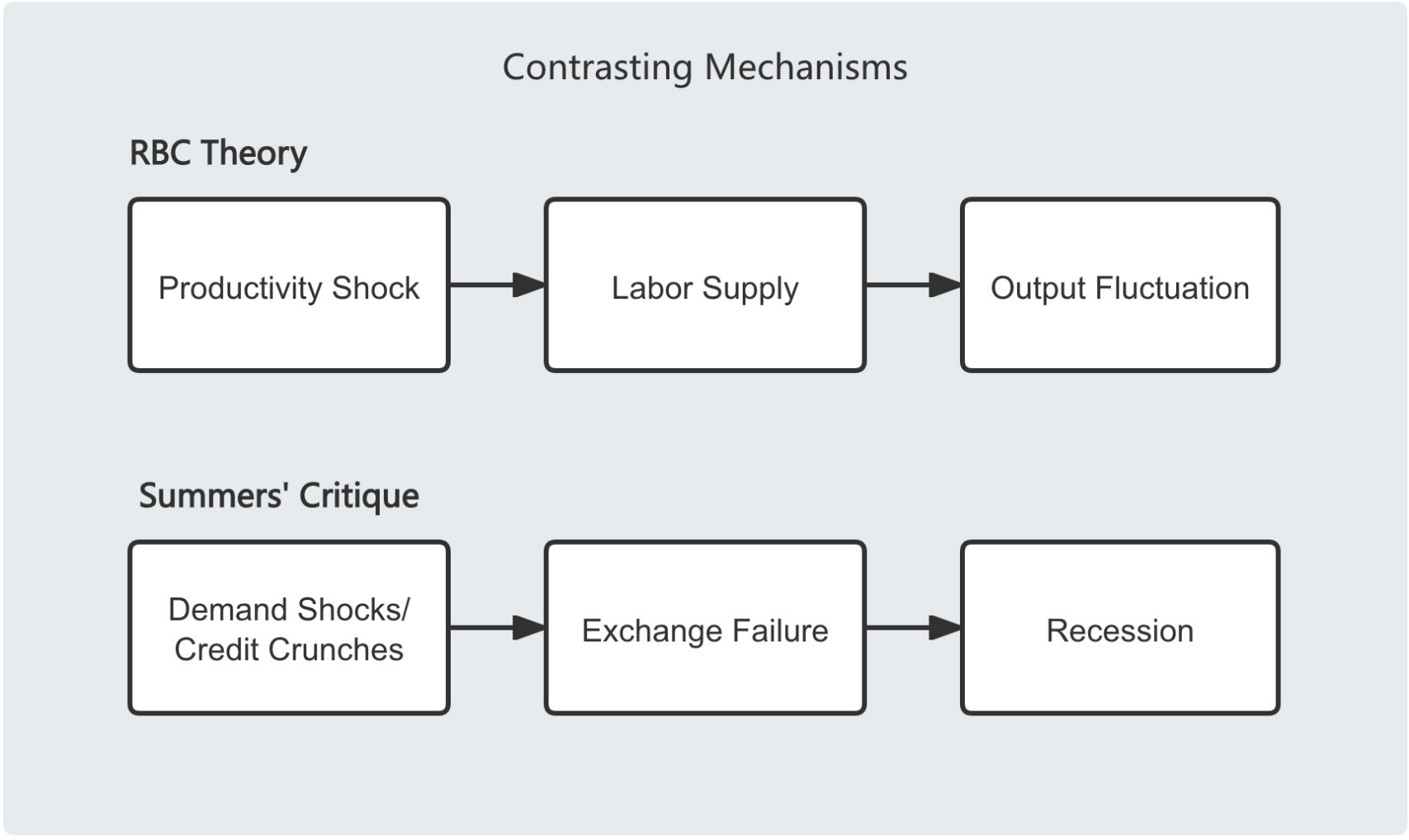
RESEARCH QUESTION

- Do Real Business Cycle models, as developed by Prescott and others, provide a convincing explanation of observed business cycle fluctuations?
- Are the assumptions (**parameters, shocks, price, mechanisms**) used in RBC models empirically valid?

ANSWER

- **Parameters not grounded:** labor supply elasticity, interest rates, and work-time shares
- **shocks lack evidence:** technology shocks are not independently observed
- **Prices ignored:** real wages, interest rates, and returns do not align with RBC predictions
- **Exchange failures overlooked:** depressions and recessions better explained by credit market breakdowns and rigidities

ILLUSTRATION



POSITIONING

- Builds on skepticism toward RBC in the 1980s.
- Contrasts with Prescott's "Theory Ahead of Measurement."
- Anticipates later New Keynesian focus on nominal rigidities, credit frictions, and demand-driven cycles.
- Reinforces empirical work.

CONCLUSION

- Limitations of RBC: unrealistic parameters, unobserved shocks, neglect of prices and exchange mechanisms.
- Improvement needed: models must incorporate price dynamics, labor market frictions, and financial constraints.
- Further questions:
  - How do monetary and fiscal policies matter under realistic frictions?
  - Can hybrid models (RBC + Keynesian elements) better explain cycles?