MODERN BUSINESS CYCLE THEORY pdf

1: Anti-Dismal: Modern business cycle theory (updated)

The chapters include expositions of growth theory, real models of business fluctuations, the informational role of prices, consumption, fiscal policy, rules versus discretion in monetary policy, time consistency and policy, and monetary models.

In this tiny paper, a possible framework for a structuralist analysis of modern business-cycle theory is considered. In order to respond to the debates around the realist and instrumentalist interpretations of the works of Friedman I will provide a framework in which the tension between the opposite standpoints can be overcome. I will argue that causal realism requires one to be realist regarding the assumptions defining agents as well. B22, B41 It was Hoover who provided the strongest stimulus to analysing the problem of the ontological status of modern business-cycle models in a structuralist framework. For Hoover, Friedman designed his assumptions with a view to causal realism. This stance can be boiled down to a tenet in structural realism according to which our theories do not need to be approximately true if one is satisfied with a model appropriately highlighting the structure of the relevant facet of reality. Theories do not need to be more than useful fictions if the relevant causal mechanisms are effectively brought to the fore Psillos, , p. In this case, as Psillos puts it, objects entities play only a heuristic role and they are confined to allowing for the introduction of the fundamental structures that carry the ontological weight. So, we need to reconceptualise the entities in a structuralist manner. In this case, structural realism and an entity-level instrumentalism go hand in hand. I think, this mix describes most clearly how Hoover interpreted F The problem is even more difficult for the descriptions of epistemic structural realism ESR and ontic structural realism OSR often intermingle. It seems to be correct to say that in the case of ESR no emphasis is on entity-descriptions. Although it is the entities who carry the relations, these relations are conceived to be describable even without entities and their first-order properties, for the entities are unobservable and hidden behind the veil of agnosticism. OSR has a more radical standpoint. In this framework, entities are only the nodes of a structure. Entities are completely dissolved in the structure due to their structuralist decomposition. Structures do not need to be underpinned by related objects and their properties. In OSR as well, the emphasis is still on structures, while conceptualising entities in structuralist terms. Even though entities are conceived to be in existence, structures have grown to be exclusive and ontologically primary whilst entities are metaphysically otiose. Whilst ESR refers to an alleged epistemological constraint that prevents us from knowing the unobservable entities, OSR eliminates such objects Chakravartty, It is possible to cite an ontology other than our common, object-oriented one, but it is still questionable whether the idea of structures without related objects is viable at all Stanford, , p. In terms of the relation-relata connection, Chakravartty , p. For the time being, it is doubtful whether OSR can successfully solve this dependence. In a social scientific context as well, OSR would entail a worldview in which the surrounding reality is only structure and nothing else. However, attributing this stance to F53 seems to be implausible. Not only for OSR is tied to quantum mechanics Morganti, , p. This project can hardly be reconciled with a metaphysical foundation that eliminates the individual as a micro-unit in order to abandon the object-oriented ontology French, , p. Such a worldview means that structure is not supervenient on the existence and properties of individual objects. However, economics is not like this. Friedman was particularly willing to apply assumptions defining economic agents, thus his focus on the structure was unlikely to drift him even to OSR. Such an interpretation would seriously distort his theoretical stance. By contrast, Friedman attributed distinct properties to his agents and built the structure upon the relations of these properties. The genuine question is whether a verisimilar structure-representation requires a distinct way of designing agent-level properties. Within the framework of ESR the problem I can solve is whether the representation of relations can be separated from the representation of entities. I will argue that structural realism cannot do without entity realism. In other words, a structuralism detached from the representation of entities i. Structure and causality are of primary importance in creating scientific knowledge. In these terms, the only problem is that knowledge of a structure cannot be separated from the knowledge of entities. Their causal properties and dispositions are of crucial importance in forming their causal relations. Entities having other properties stand

in other relations, thus properties of entities are not neutral in terms of relations. The core of the problem lies beyond the fact that our assumptions used in models are empirically invalid Weber, , p. One is the pure instrumentalism. The other that Weber attributed to neoclassical economics is the realist case providing concepts that can be regarded as approximately true. Weberian ideal-types are built upon such realist assumptions that are devoted to highlighting the real causal structures. It is questionable whether both methodologies are compatible with macro-level causal realism, or casual realism requires some realism of entity-descriptions. Richard Boyd stands up for a naturalistic theory of reference the most important task of which is to clarify how to design the assumptions that define the entities. Thus, the content of the concepts we use is established by the real properties of real entities. However, this is still not the case of direct description. Even though we can make it a requirement that our concepts should refer on the basis of real properties, this is not an effective argument for entity-realism in order to achieve structural realism. It is worthwhile to consider why causal realism can be discussed in the context of structural and entity realism. There is no unique and commonly accepted view on the relationship between causality and the fundamental structures. Advocates of OSR pay particular attention to the close connection of causality and structure. For him, fundamental structures are causal structures. The structuralist reconceptualization of entities and their properties means that relations possess inherent causal empowerment. However, Psillos thinks that OSR is not an adequate framework for causal considerations since in this framework cause and effect are impossible to distinguish. Psillos conceives structuralism to be insufficient on its own to draw this distinction, so he puts causality back into object-oriented ontology, where structures relate entities having properties. By so doing, he can discuss causality and structure simultaneously. Chakravartty has no difficulties in giving high priority to entity-level properties in the context of causality and structures, since he does not doubt the existence of these detectable properties. Thus, such properties can play a crucial role in 5 causality. For him, structure is made up of the relations between causal properties, and it is these causal properties that make entities have certain dispositions and causal roles. Causality works along the relations between causal properties. Entities possessing definite properties serve as an ontological resource on the basis of which change can be conceptualized. Changes happen to objects, and what happens is dependent on the properties of objects and other related objects. In the usual concept of causality, the assumed nature of time raises some concerns. Meanwhile, causality relating events as a simplification can remain in use. The most profound objection to causality concerns the very nature of causal mechanisms. Moreover, he puts forward a more tenable suggestion as for causal mechanisms. By this shift, in terms of causality the emphasis relocates to the properties of entities. These properties explain how the entities behave in certain situations and under certain circumstances. Thus, it is the properties of entities and not the events themselves that are related in a causal structure. Events look like being adjusted along a causal chain, since it is the entities the causal properties of which and their relations set up the casual mechanism in fact. Causal structures are made up of the relations between causal properties: A causal property confers dispositions for behaviour: So, it is causal interaction of objects that underlie causality. In such interactions, properties undergo changes and the behaviour of entities also change 6 consequently. This approach solves the problem of events acting as causes and effects, since entities with causal properties are involved in continuous process of interactions. Thus, a causal mechanism is a system of relations between properties that make the entities involved in causal interactions. This approach is particularly beneficial to economic epistemology, since it facilitates the study of economic laws. Entities with the same property behave in the same way under the same circumstances which makes it possible to draw general laws. Thus, together with causal processes general laws are also traced back to the properties and their relations. This is the reason why causal realism can be discussed in the framework of structural realism. In other approaches, such a direct identification is impossible. In the traditional interpretation, a causal mechanism relates events, while a structure relates objects. Therefore, the analysis of causal realism both in general and in particular cases can be carried out in the more sophisticated framework of structural realism. Chakravartty and OSR agree on that fundamental structures are causal structures , p. However, for Chakravartty, causal connections stem from entity properties standing in relations. It is still possible that causal mechanisms can soundly be conceptualised in OSR as well. But if one picks objects to be the primitives

in his theory, he cannot be satisfied with instrumentalist entity-level assumptions, given that structures consist of the relations between entity properties. On this showing, it stands to reason that verisimilar structure descriptions require verisimilar entity descriptions. In the literature, there is a common trend for confronting entity realism and structural realism. The latter option makes sense only if structural realism is not to have entity realism as a prerequisite Worrall, ; Psillos, , p. Scientific realism, be it structural or entity realism, is rarely more than highlighting some relevant partial truths. Thus, if structural 7 realism is detached from entity realism, it amounts to abandoning the requirement of the correspondence i. This problem concerns the correspondence between the properties of our entities objects or agents in the case of economics and reality Giere, , p. If we conceive structure to be observable whilst entities are unobservable Laudan, , pp. If structure is independent of the related entities, it would be unnecessary to give up entity realism and reference. If our entities are really independent of the embedding structure, then we have no reason to draw up entity descriptions that lie cross to everyday or common-sense experience strictly speaking, in such a case we would not need entities either. Even though in physics we are uncertain of the nature of the entities beyond experience, this tenet cannot be a principled argument in economics for setting aside what we know or can reasonably assume4 Psillos, , p.

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2: Theories of Business Cycles (Explained With Diagram)

real business cycle theory is a business cycle application of theArrow-Debreu model, which is the standard general equilibrium theory of market economies. Let us brieï¬,y outline the mechanics of an RBC model.

There were great increases in productivity , industrial production and real per capita product throughout the period from to that included the Long Depression and two other recessions. Both the Long and Great Depressions were characterized by overcapacity and market saturation. Productivity improving technologies historical. A table of innovations and long cycles can be seen at: There were frequent crises in Europe and America in the 19th and first half of the 20th century, specifically the period â€" This period started from the end of the Napoleonic wars in , which was immediately followed by the Post-Napoleonic depression in the United Kingdom â€"30 , and culminated in the Great Depression of â€"39, which led into World War II. The first of these crises not associated with a war was the Panic of The first declaration was in the late s, when the Phillips curve was seen as being able to steer the economy. However, this was followed by stagflation in the s, which discredited the theory. The second declaration was in the early s, following the stability and growth in the s and s in what came to be known as The Great Moderation. Notably, in , Robert Lucas , in his presidential address to the American Economic Association , declared that the "central problem of depression-prevention [has] been solved, for all practical purposes. Various regions have experienced prolonged depressions , most dramatically the economic crisis in former Eastern Bloc countries following the end of the Soviet Union in For several of these countries the period â€" has been an ongoing depression, with real income still lower than in Economic activity in the US, â€" Deviations from the long-term US growth trend, â€" In , economists Arthur F. Burns and Wesley C. Mitchell provided the now standard definition of business cycles in their book Measuring Business Cycles: The critical feature that distinguishes them from the commercial convulsions of earlier centuries or from the seasonal and other short term variations of our own age is that the fluctuations are widely diffused over the economy â€" its industry, its commercial dealings, and its tangles of finance. The economy of the western world is a system of closely interrelated parts. He who would understand business cycles must master the workings of an economic system organized largely in a network of free enterprises searching for profit. The problem of how business cycles come about is therefore inseparable from the problem of how a capitalist economy functions. An expansion is the period from a trough to a peak, and a recession as the period from a peak to a trough. The NBER identifies a recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production". For example, Milton Friedman said that calling the business cycle a "cycle" is a misnomer , because of its non-cyclical nature. Friedman believed that for the most part, excluding very large supply shocks, business declines are more of a monetary phenomenon. The main framework for explaining such fluctuations is Keynesian economics. In the Keynesian view, business cycles reflect the possibility that the economy may reach short-run equilibrium at levels below or above full employment. If the economy is operating with less than full employment, i. Beside the Keynesian explanation there are a number of alternative theories of business cycles, largely associated with particular schools or theorists in heterodox economics. A common alternative within mainstream economics is real business cycle theory. Nowadays other notable theories are credit-based explanations such as debt deflation and the financial instability hypothesis. The latter two gained interest for being able to explain the subprime mortgage crisis and financial crises. These may also broadly be classed as "supply-side" and "demand-side" explanations: This debate has important policy consequences: This division is not absolute â€" some classicals including Say argued for government policy to mitigate the damage of economic cycles, despite believing in external causes, while Austrian School economists argue against government involvement as only worsening crises, despite believing in internal causes. Until the Keynesian revolution in mainstream economics in the wake of the Great Depression , classical and neoclassical explanations exogenous causes were the mainstream explanation of economic cycles; following the Keynesian revolution, neoclassical macroeconomics was largely rejected. There has been some resurgence of neoclassical approaches in the form of real business cycle RBC theory.

The debate between Keynesians and neo-classical advocates was reawakened following the recession of Mainstream economists working in the neoclassical tradition, as opposed to the Keynesian tradition, have usually viewed the departures of the harmonic working of the market economy as due to exogenous influences, such as the State or its regulations, labor unions, business monopolies, or shocks due to technology or natural causes. Keynesian[edit] According to Keynesian economics , fluctuations in aggregate demand cause the economy to come to short run equilibrium at levels that are different from the full employment rate of output. These fluctuations express themselves as the observed business cycles. Keynesian models do not necessarily imply periodic business cycles. However, simple Keynesian models involving the interaction of the Keynesian multiplier and accelerator give rise to cyclical responses to initial shocks. The amplitude of the variations in economic output depends on the level of the investment, for investment determines the level of aggregate output multiplier , and is determined by aggregate demand accelerator. The fluctuations in wages are almost the same as in the level of employment wage cycle lags one period behind the employment cycle , for when the economy is at high employment, workers are able to demand rises in wages, whereas in periods of high unemployment, wages tend to fall. According to Goodwin, when unemployment and business profits rise, the output rises. Credit cycle and Debt deflation One alternative theory is that the primary cause of economic cycles is due to the credit cycle: In particular, the bursting of speculative bubbles is seen as the proximate cause of depressions, and this theory places finance and banks at the center of the business cycle. A primary theory in this vein is the debt deflation theory of Irving Fisher , which he proposed to explain the Great Depression. A more recent complementary theory is the Financial Instability Hypothesis of Hyman Minsky , and the credit theory of economic cycles is often associated with Post-Keynesian economics such as Steve Keen. Post-Keynesian economist Hyman Minsky has proposed an explanation of cycles founded on fluctuations in credit, interest rates and financial frailty, called the Financial Instability Hypothesis. In an expansion period, interest rates are low and companies easily borrow money from banks to invest. Banks are not reluctant to grant them loans, because expanding economic activity allows business increasing cash flows and therefore they will be able to easily pay back the loans. This process leads to firms becoming excessively indebted, so that they stop investing, and the economy goes into recession. Real business cycle theory[edit] Main article: Real Business Cycle theory Within mainstream economics, Keynesian views have been challenged by real business cycle models in which fluctuations are due to technology shocks. This theory is most associated with Finn E. Kydland and Edward C. Prescott , and more generally the Chicago school of economics freshwater economics. They consider that economic crisis and fluctuations cannot stem from a monetary shock, only from an external shock, such as an innovation. Vernon stated that some countries specialize in the production and export of technologically new products, while others specialize in the production of already known products. The most developed countries are able to invest large amounts of money in the technological innovations and produce new products, thus obtaining a dynamic comparative advantage over developing countries. Recent research by Georgiy Revyakin proves initial Vernon theory and shows that economic cycles in developed countries overrun economic cycles in developing countries. In case of Kondratiev waves such products correlate with fundamental discoveries implemented in production inventions which form the technological paradigm: Simultaneous technological updates by all economic agents as a result, cycle formation would be determined by highly competitive market conditions: Politically based business cycle[edit] Another set of models tries to derive the business cycle from political decisions. The partisan business cycle suggests that cycles result from the successive elections of administrations with different policy regimes. Regime A adopts expansionary policies, resulting in growth and inflation, but is voted out of office when inflation becomes unacceptably high. The replacement, Regime B, adopts contractionary policies reducing inflation and growth, and the downwards swing of the cycle. It is voted out of office when unemployment is too high, being replaced by Party A. The political business cycle is an alternative theory stating that when an administration of any hue is elected, it initially adopts a contractionary policy to reduce inflation and gain a reputation for economic competence. It then adopts an expansionary policy in the lead up to the next election, hoping to achieve simultaneously low inflation and unemployment on election day. In recent years, proponents of the "electoral business cycle" theory[who? Marxian

economics[edit] For Marx the economy based on production of commodities to be sold in the market is intrinsically prone to crisis. In the heterodox Marxian view profit is the major engine of the market economy, but business capital profitability has a tendency to fall that recurrently creates crises, in which mass unemployment occurs, businesses fail, remaining capital is centralized and concentrated and profitability is recovered. In the long run these crises tend to be more severe and the system will eventually fail. Henryk Grossman [33] reviewed the debates and the counteracting tendencies and Paul Mattick subsequently emphasized the basic differences between the Marxian and the Keynesian perspective: Goodwin formalised a Marxist model of business cycles, known as the Goodwin Model in which recession was caused by increased bargaining power of workers a result of high employment in boom periods pushing up the wage share of national income, suppressing profits and leading to a breakdown in capital accumulation. Later theorists applying variants of the Goodwin model have identified both short and long period profit-led growth and distribution cycles in the United States, and elsewhere. Austrian business cycle theory Economists of the heterodox Austrian School argue that business cycles are caused by excessive issuance of credit by banks in fractional reserve banking systems. According to Austrian economists, excessive issuance of bank credit may be exacerbated if central bank monetary policy sets interest rates too low, and the resulting expansion of the money supply causes a "boom" in which resources are misallocated or "malinvested" because of artificially low interest rates. Eventually, the boom cannot be sustained and is followed by a "bust" in which the malinvestments are liquidated sold for less than their original cost and the money supply contracts. Mainstream economists generally do not support Austrian school explanations for business cycles, on both theoretical as well as real-world empirical grounds. Yield curve[edit] The slope of the yield curve is one of the most powerful predictors of future economic growth, inflation, and recessions. A positively sloped yield curve is often a harbinger of inflationary growth. Work by Arturo Estrella and Tobias Adrian has established the predictive power of an inverted yield curve to signal a recession. Their models show that when the difference between short-term interest rates they use 3-month T-bills and long-term interest rates year Treasury bonds at the end of a federal reserve tightening cycle is negative or less than 93 basis points positive that a rise in unemployment usually occurs. All the recessions in the US since up through have been preceded by an inverted yield curve year vs 3-month. Over the same time frame, every occurrence of an inverted yield curve has been followed by recession as declared by the NBER business cycle dating committee.

MODERN BUSINESS CYCLE THEORY pdf

3: Modern Business Cycle Theory â€" Robert J. Barro | Harvard University Press

The new classical approach to macroeconomics, which assumes that people gather and use economic information efficiently, has been the most important theoretical advance since the Keynesian revolution of the s.

Business cycles[edit] If we were to take snapshots of an economy at different points in time, no two photos would look alike. This occurs for two reasons: Many advanced economies exhibit sustained growth over time. That is, snapshots taken many years apart will most likely depict higher levels of economic activity in the later period. There exist seemingly random fluctuations around this growth trend. Thus given two snapshots in time, predicting the latter with the earlier is nearly impossible. While we see continuous growth of output, it is not a steady increase. There are times of faster growth and times of slower growth. Figure 2 transforms these levels into growth rates of real GNP and extracts a smoother growth trend. A common method to obtain this trend is the Hodrickâ€"Prescott filter. The basic idea is to find a balance between the extent to which general growth trend follows the cyclical movement since long term growth rate is not likely to be perfectly constant and how smooth it is. The HP filter identifies the longer term fluctuations as part of the growth trend while classifying the more jumpy fluctuations as part of the cyclical component. Economists refer to these cyclical movements about the trend as business cycles. Figure 3 explicitly captures such deviations. Note the horizontal axis at 0. A point on this line indicates at that year, there is no deviation from the trend. All other points above and below the line imply deviations. By using log real GNP the distance between any point and the 0 line roughly equals the percentage deviation from the long run growth trend. Also note that the Y-axis uses very small values. This indicates that the deviations in real GNP are very small comparatively, and might be attributable to measurement errors rather than real deviations. We call relatively large negative deviations those below the 0 axis troughs. A series of positive deviations leading to peaks are booms and a series of negative deviations leading to troughs are recessions. At a glance, the deviations just look like a string of waves bunched togetherâ€"nothing about it appears consistent. To explain causes of such fluctuations may appear rather difficult given these irregularities. However, if we consider other macroeconomic variables, we will observe patterns in these irregularities. For example, consider Figure 4 which depicts fluctuations in output and consumption spending, i. Observe how the peaks and troughs align at almost the same places and how the upturns and downturns coincide. For example, a labor, hours worked b productivity, how effective firms use such capital or labor, c investment, amount of capital saved to help future endeavors, and d capital stock, value of machines, buildings and other equipment that help firms produce their goods. While Figure 5 shows a similar story for investment, the relationship with capital in Figure 6 departs from the story. We need a way to pin down a better story; one way is to look at some statistics. For example, if we take any point in the series above the trend the x-axis in figure 3 , the probability the next period is still above the trend is very high. However, this persistence wears out over time. That is, economic activity in the short run is quite predictable but due to the irregular long-term nature of fluctuations, forecasting in the long run is much more difficult if not impossible. Another regularity is cyclical variability. Column A of Table 1 lists a measure of this with standard deviations. The magnitude of fluctuations in output and hours worked are nearly equal. Consumption and productivity are similarly much smoother than output while investment fluctuates much more than output. The capital stock is the least volatile of the indicators. TABLE 1 Yet another regularity is the co-movement between output and the other macroeconomic variables. Figures 4 â€" 6 illustrated such relationship. We can measure this in more detail using correlations as listed in column B of Table 1. Procyclical variables have positive correlations since it usually increases during booms and decreases during recessions. Vice versa, a countercyclical variable associates with negative correlations. Acyclical, correlations close to zero, implies no systematic relationship to the business cycle. We find that productivity is slightly procyclical. This implies workers and capital are more productive when the economy is experiencing a boom. They are not quite as productive when the economy is experiencing a slowdown. Similar explanations follow for consumption and investment, which are strongly procyclical. Labor is also procyclical while capital stock appears acyclical. Observing these similarities yet seemingly non-deterministic fluctuations about trend, the

question arises as to why any of this occurs. Since people prefer economic booms over recessions, it follows that if all people in the economy make optimal decisions, these fluctuations are caused by something outside the decision-making process. So the key question really is: Economists have come up with many ideas to answer the above question. The one which currently dominates the academic literature on real business cycle theory[citation needed] was introduced by Finn E. Kydland and Edward C. They envisioned this factor to be technological shocksâ€”i. Examples of such shocks include innovations, bad weather, imported oil price increase, stricter environmental and safety regulations, etc. This in turn affects the decisions of workers and firms, who in turn change what they buy and produce and thus eventually affect output. RBC models predict time sequences of allocation for consumption, investment, etc. But exactly how do these productivity shocks cause ups and downs in economic activity? This momentarily increases the effectiveness of workers and capital, allowing a given level of capital and labor to produce more output. Individuals face two types of tradeoffs. One is the consumption-investment decision. Since productivity is higher, people have more output to consume. An individual might choose to consume all of it today. But if he values future consumption, all that extra output might not be worth consuming in its entirety today. Instead, he may consume some but invest the rest in capital to enhance production in subsequent periods and thus increase future consumption. This explains why investment spending is more volatile than consumption. The life cycle hypothesis argues that households base their consumption decisions on expected lifetime income and so they prefer to "smooth" consumption over time. They will thus save and invest in periods of high income and defer consumption of this to periods of low income. The other decision is the labor-leisure tradeoff. Higher productivity encourages substitution of current work for future work since workers will earn more per hour today compared to tomorrow. More labor and less leisure results in higher output today. On the other hand, there is an opposing effect: However, given the pro-cyclical nature of labor, it seems that the above substitution effect dominates this income effect. Overall, the basic RBC model predicts that given a temporary shock, output, consumption, investment and labor all rise above their long-term trends and hence formulate into a positive deviation. Furthermore, since more investment means more capital is available for the future, a short-lived shock may have an impact in the future. That is, above-trend behavior may persist for some time even after the shock disappears. This capital accumulation is often referred to as an internal "propagation mechanism", since it may increase the persistence of shocks to output. A string of such productivity shocks will likely result in a boom. Similarly, recessions follow a string of bad shocks to the economy. If there were no shocks, the economy would just continue following the growth trend with no business cycles. To quantitatively match the stylized facts in Table 1, Kydland and Prescott introduced calibration techniques. Using this methodology, the model closely mimics many business cycle properties. Yet current RBC models have not fully explained all behavior and neoclassical economists are still searching for better variations. The main assumption in RBC theory is that individuals and firms respond optimally all the time. It follows that business cycles exhibited in an economy are chosen in preference to no business cycles at all. This is not to say that people like to be in a recession. Slumps are preceded by an undesirable productivity shock which constrains the situation. But given these new constraints, people will still achieve the best outcomes possible and markets will react efficiently. So when there is a slump, people are choosing to be in that slump because given the situation, it is the best solution. This suggests laissez-faire non-intervention is the best policy of government towards the economy but given the abstract nature of the model, this has been debated. This meant they worked and consumed more or less than otherwise. In a world of perfect information, there would be no booms or recessions. Calibration[edit] Unlike estimation, which is usually used for the construction of economic models, calibration only returns to the drawing board to change the model in the face of overwhelming evidence against the model being correct; this inverts the burden of proof away from the builder of the model. In fact, simply stated, it is the process of changing the model to fit the data. Since RBC models explain data ex post, it is very difficult to falsify any one model that could be hypothesised to explain the data. RBC models are highly sample specific, leading some[who? Structural variables[edit] Crucial to RBC models, "plausible values" for structural variables such as the discount rate, and the rate of capital depreciation are used in the creation of simulated variable paths.

MODERN BUSINESS CYCLE THEORY pdf

4: What is modern business cycle theory | The visible hand in economics

Modern Business Cycle Theory / Edition 1 The new classical approach to macroeconomics, which assumes that people gather and use economic information efficiently, has been the most important theoretical advance since the Keynesian revolution of the s.

Some of the most important theories of business cycles are as follows: Pure Monetary Theory 2. Monetary Over-Investment Theory 3. A number of theories have been developed by different economists from time to time to understand the concept of business cycles. In the first half of twentieth century, various new and important concepts related to business cycles come into existence. However, in nineteenth century, many of the classical economists, such as Adam Smith, Miller, and Ricardo, have conducted a study on business cycles. They believed that stability of an economy depends on market forces. After that, many other economists, such as Keynes and Hick, had provided a framework to understand business cycles. The different theories of business cycle are shown in Figure The different theories of business cycles as shown in Figure-3 are explained in detail. The traditional business cycle theorists take into consideration the monetary and credit system of an economy to analyze business cycles. Therefore, theories developed by these traditional theorists are called monetary theory of business cycle. The monetary theory states that the business cycle is a result of changes in monetary and credit market conditions. Hawtrey, the main supporter of this theory, advocated that business cycles are the continuous phases of inflation and deflation. According to him, changes in an economy take place due to changes in the flow of money. For example, when there is increase in money supply, there would be increase in prices, profits, and total output. This results in the growth of an economy. On the other hand, a fall in money supply would result in decrease in prices, profit, and total output, which would lead to decline of an economy. Apart from this, Hawtrey also advocated that the main factor that influences the flow of money is credit mechanism. In economy, the banking system plays an important role in increasing money flow by providing credit. An economy shows growth when the volume of bank credit increases. This increase in the growth continues till the volume of bank credit increases. Banks offer credit facilities to individuals or organizations due to the fact that banks find it profitable to provide credit on easy terms. The easy availability of funds from banks helps organizations to perform various business activities. This leads to increase in various investment opportunities, which further results in deepening and widening of capital. Apart from this, credit provided by banks on easy terms helps organizations to expand their production. When an organization increases its production, the supply of its products also increases to a certain limit. After that, the rate of increase in demand of products in market is higher than the rate of increase in supply. Consequently, the prices of products increases. Therefore, credit expansion helps in expansion of economy. On the contrary, the economic condition is reversed when the bank starts withdrawing credit from market or stop lending money. This is because of the reason that the cash reserves of bank are washed-out due to the following reasons: Increase in loans and advance provided by banks b. Withdrawal of deposits for better investment opportunities When banks stop providing credit, it reduces investment by businessmen. This leads to the decrease in the demand for consumer and capital goods, prices, and consumption. This marks the symptoms of recession. Some of the points on which the pure monetary theory is criticized are as follows: Regards business cycle as monetary phenomenon that is not true. Apart from monetary factors, several non-monetary factors, such as new investment demands, cost structure, and expectations of businessmen, can also produce changes in economic activities. Describes only expansion and recession phases and fails to explain the intermediary phases of business cycles. Assumes that businessmen are more sensitive to the interest rates that is not true rather they are more concerned about the future opportunities. Monetary over-investment theory focuses mainly on the imbalance between actual and desired investments. According to this theory, the actual investment is much higher than the desired investment. This theory was given by Hayek. According to him, the investment and consumption patterns of an economy should match with each other to bring the economy in equilibrium. For stabilizing this equilibrium, the voluntary savings should be equal to actual investment in an economy. In an economy, generally, the total investment is distributed among industries in such a way that

each industry produces products to a limit, so that its demand and supply are equal. This implies that the investment at every level and for every product in the whole economy is equal. As a result, there would be no expansion and contraction and the economy would always be in equilibrium. According to this theory, changes in economic conditions would occur only when the money supply and investment-saving relations show fluctuations. The investment-saving relations are affected when there is an increase in investment opportunities and voluntary savings are constant. Investment opportunities increase due to several reasons, such as low interest rates, increased marginal efficiency of capital, and increase in expectations of businessmen. Apart from this, when banks start supporting industries for investment by lending money at lower rates, it results in an increase in investment. In such a case, investment and savings increase, but the consumption remains unaffected as there is no change in consumer goods industries. Consequently, profit increases with increase in investment opportunities, which further results in an increase in the demand for various products and services. The demand for products and services exceeds the supply of products and services. This leads to inflation in the economy, which reduces the purchasing power of individuals. Therefore, with decrease in the purchasing power of individuals, the real demand for products does not increase at the same rate at which the investment increases. The real investment is done at the cost of real consumption. The balance between the investment and consumer demand is disturbed. As a result, it is difficult to maintain the current rate of investment. The demand of consumer goods would be dependent on the income of individuals. An increase in the income level would result in the increase of consumer goods. However, the increase in consumer goods is more than the increase in capital goods. Therefore, people would invest in consumer goods rather than in capital goods. Consequently, the demand for bank credit also increases. However, the bankers are not ready to lend money because of the demand for funds from consumer and capital goods industry both. This leads to recession in the economy. As a result, economic activities, such as employment, investment, savings, consumption, and prices of goods and services, start declining. Some of the limitations of monetary over-investment theory are as follows: Assumes that when the market rate of interest is lower than the natural market rate of interest, the bank credit flows to the capital goods industry. This is applicable only in the situation of full employment. However, business cycles are the part of an economy and can take place under improper utilization of resources. Considers interest rate as the most important factor that affects investment. However, there are several factors, such as capital goods cost and businessmen expectations, which can influence investment. Focuses on balance between consumer goods and investment, which is not much required. The other theories of business cycles lay emphasis on investment and monetary expansion. Innovations are such changes of the combination of the factors of production as cannot be effected by infinitesimal steps or variations on the margin. In addition, he propounded that innovations are responsible for the occurrence of business cycles. He also designed a model having two stages, namely, first approximation and second approximation. The two stages of the model are discussed as follows: Deals with the effect of innovatory ideas on an economy in the beginning. First approximation is the startup stage of innovation in which the economy is in equilibrium. In addition, at this stage, there is no involuntary unemployment. In equilibrium, organizations lack idle funds or surplus funds to invest. In such a case, banks are the only source of funds for innovators. When the innovators get the desired fund from banks, they purchase inputs for production at a higher price to make these inputs available only for innovation purposes. Increase in prices of inputs result in the rise of prices. Over time, competitors also start copying innovation and acquire funds from bank. As a result, the output and profit of organizations start increasing. However, after a certain point of time, profit shows decline with a decrease in output prices. Simultaneously, debtors need to repay their debts to bank. This leads to decrease in the flow of money, which finally results in recession. Deals with the subsequent effects of first approximation. It is related to the speculation of future economic conditions. In first approximation, it is assumed by investors that the expansion phase would not be affected in future, especially in capital goods industries. On the basis of this belief, investors take large amounts of money from banks. In addition, in this stage, customers perceive an increase in the durable goods in future and therefore, start purchasing goods at present by borrowing funds. When the prices start falling, debtors are in the worst situation because they are not able to repay loan and meet their basic needs.

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Before this strain of thought came out, business cycle theory was a surprising holistic section of economics - something that did not match with the individualistic nature of microeconomics (see Schumpeter). Furthermore, business cycle theory, long-term growth theory, and near term macroeconomics (effectively old school Keynesianism) were.

8: Business cycle - Wikipedia

Real Business Cycle Models methods is summarized and a few tentative conclusions regarding business cycle research are suggested. Modern Business Cycle Theory.

9: Real business-cycle theory - Wikipedia

The business cycle, also known as the economic cycle or trade cycle, is the downward and upward movement of gross domestic product (GDP) around its long-term growth trend. The length of a business cycle is the period of time containing a single boom and contraction in sequence.

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