M.A. Economics (Semester-II)
Macroeconomics-II: ECON4007

REAL BUSINESS CYCLE MODEL

(Part – A)

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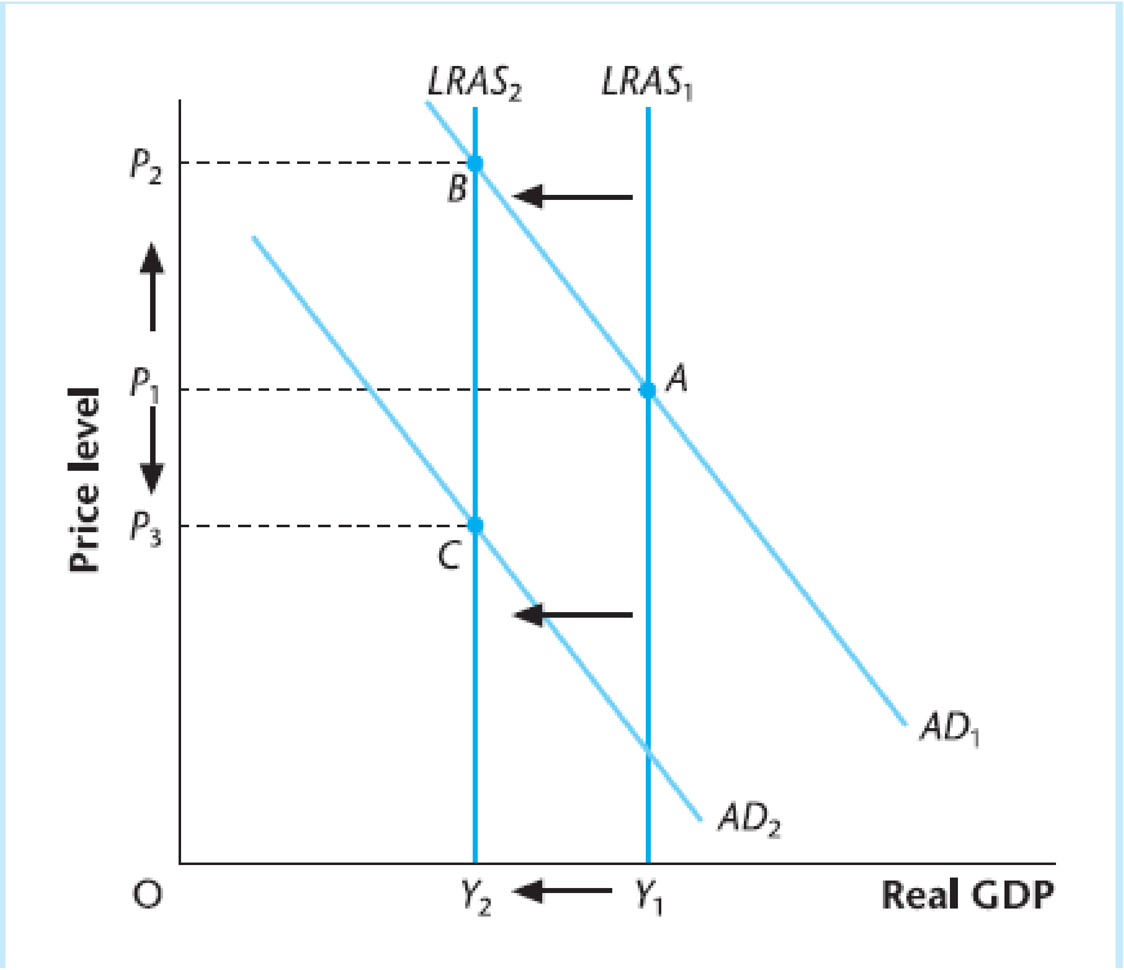
Real Business Cycle Model: an elementary idea

Real Business cycle theorists maintain that a business cycle contraction may be caused by a major supply-side shock. Such a shock reduces the potential productive capacity of the economy.

Similarly, a supply-side event that increases the economy's capacity to produce may cause an expansion.

Supply-side shocks that could trigger a business cycle may include:

i. **national disasters** (e.g. famines, floods, droughts, earthquakes, Covid19 type health emergencies);
ii. **international disturbances** (e.g. debt crises, wars and stock market collapses);
iii. **technological changes** (e.g. resulting from new inventions and innovations leading to increased productivity).



Real Business Cycle Theory - Contraction

An adverse supply-side shock reduces the productive capacity of the economy. It shifts the long-run aggregate supply curve to the left from $LRAS_1$ to $LRAS_2$.

With the aggregate demand AD_1, this leftward shift of LRAS will result in a movement from A to B. It leads to a rise in the price level from P_1 to P_2, and a fall in real GDP from Y_1 to Y_2. Thus, in this case, recession is combined with inflation. This situation is commonly referred to as **stagflation.**

As output falls, firms will reduce their demand for labour.

A lower demand for labour will put downward pressure on money wages.

Given the higher price level, real wages (w/p) will fall.

With lower real wages, household consumption can be expected to decline. The aggregate demand shifts from AD_1 to AD_2 and the price level falls to P_3.

This effect is reinforced by a likely decline in business confidence leading to reduced investment and a consequent decline in the production potential of the economy.

The crucial point here is the correct identification of cause and effect as both AD and LRAS shift. The fact that the initial change is on the supply-side must not be overlooked.

The critics of the real business cycle theory argue that supply-induced shocks are unlikely to lead to the scales of swings in output and employment seen over the years in many countries.

Instead, the critics argue that such swings are more likely to be caused by fluctuations in aggregate demand.

The appropriate policy response to a business cycle depends upon which theory of the business cycle favoured.

Defenders of the real business cycle theory raise the possibility that business cycle is efficient.

Recessions create the scope for beneficial resource allocation from lower to higher productivity activities.

Defenders of the real business cycle theory argue that policy makers should not intervene at all on the demand-side of the economy. Instead, encouragement should be given to the development of technologies that support faster long-term economic growth.