Testing Output-inflation Trade-off: A Note

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Abstract:

This study estimates the Asai (1999) proposed simplified BMR model (Ball et al., 1988) and ARY model (Akerlof et al., 1988) using quarterly data from Malaysia, Thailand, Japan and US. Unlike other earlier authors, we ensure that our models' residuals are free from serial correlation and ARCH effects. For the ARY model, Malaysia and US show strong evidence for new Keynesian model, while Thailand and Japan produce inconclusive results. As for the BMR model, all countries provide strong evidence for new Keynesian model. Our finding implies that government generally plays a significant role in altering the economy's business cycle. Besides, this study suggests that future researchers should do and report residuals diagnostic tests to show the viability of their results.

Key words: Business cycle; New Keynesian model; New classical model.

1. Introduction

Macroeconomists have long been concerned whether allowing the economy to operate freely under market force will be more successful in achieving macroeconomic goals than otherwise. Most related studies are conducted based on the new classical and new Keynesian hypotheses.

In the new classical hypothesis, market force functions well and government intervention should not exist because it is believed that: (a) inflation is more costly than unemployment; (b) short-run Phillips curve is quite steep; the economy's self-correcting mechanisms work smoothly and quickly. The new Keynesians, on the other hand, do not believe in market force and they argue that government intervention is important because: (a) unemployment is more costly than inflation; (b) short-run Philips curve is rather flat; (c) the economy's self-correcting mechanism is slow and unreliable.

The new classical economies and the real business cycle theory are based on the dual assumptions of rational expectations and continual market clearing. As a result, according