The Self Adjusting Mechanism

AD_0

P_0

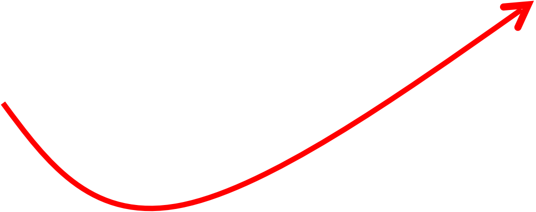
5,000

4,000

$$AS(W_1)$$

P_1

Potential GDP



Inflationary Gap

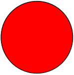
$AS(W_2)$

Labor market shortages: Difficult for firms to hire, easy for workers to win wage increases

Wages rise AS shifts left

As prices rise, Aggregate Demand decreases: gap closes

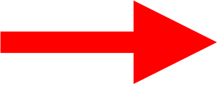
Excessive spending is eliminated by the increase in prices

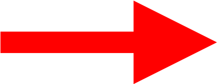


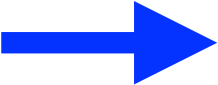
Labor shortages cause wages to rise

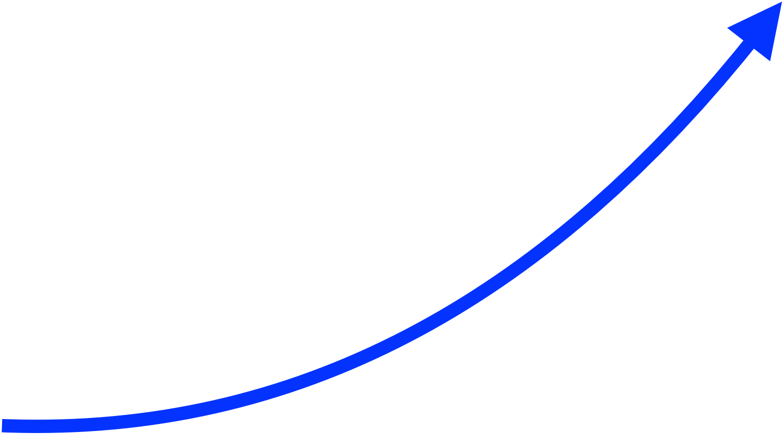
and then, prices rise

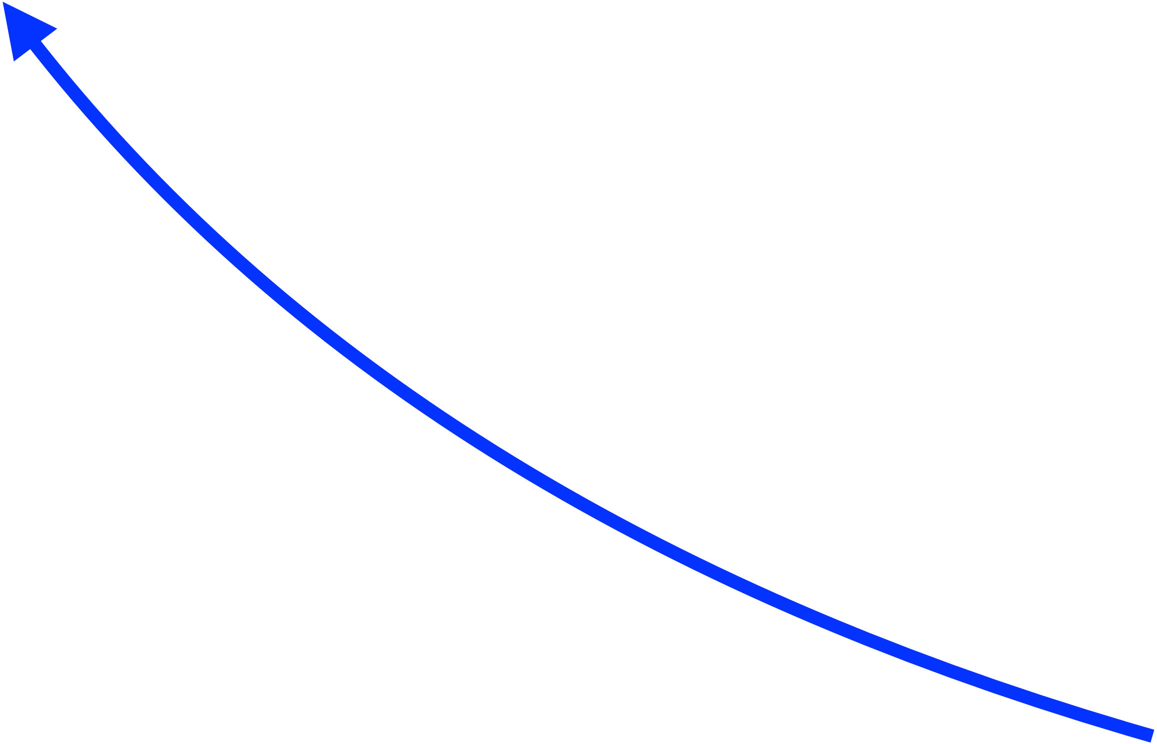
Excessive spending

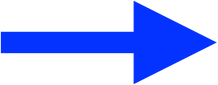










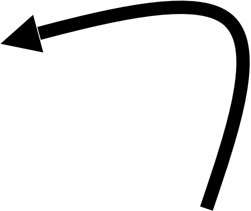


The Self Adjusting Mechanism works through automatic changes in wages and prices

2

3

Economy starts at 1, with the shift in AS moves to 2 and with the increase in prices ends at 3

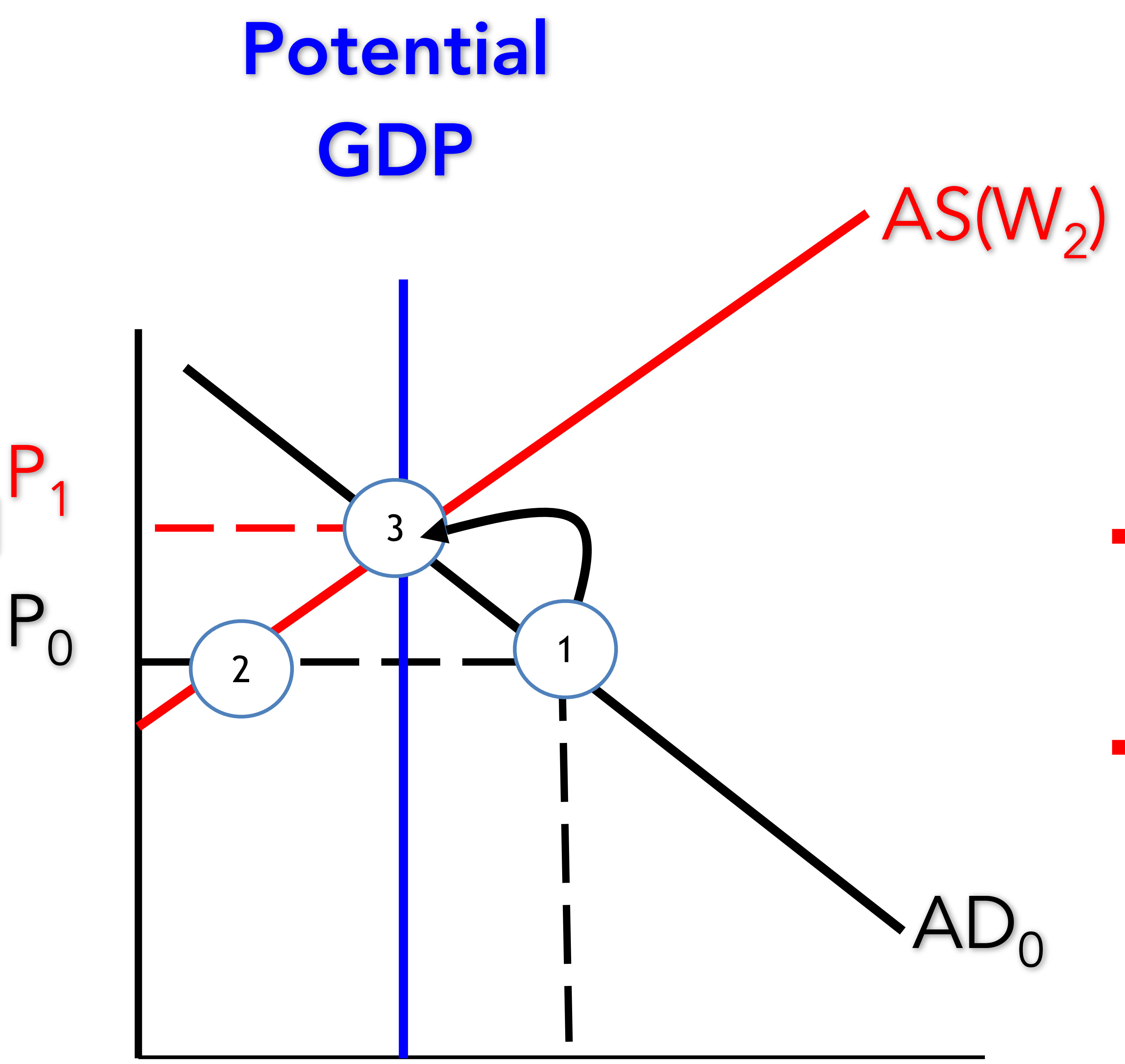


1

The Self Adjusting Mechanism works through automatic changes in wages and prices

Economy starts at 1, with the shift in AS moves to 2 and with the increase in prices ends at 3

As prices rise, Aggregate Demand decreases: gap closes



Excessive spending → Excessive spending is eliminated by the increase in prices

Labor market shortages: Difficult for firms to hire, easy for workers to win wage increases → Wages rise AS shifts left

Labor shortages cause wages to rise and then, prices rise

The Self Adjusting Mechanism