The Self Adjusting Mechanism

AD_0

P_0

[redacted] [redacted] [redacted] [redacted] [redacted] [redacted]

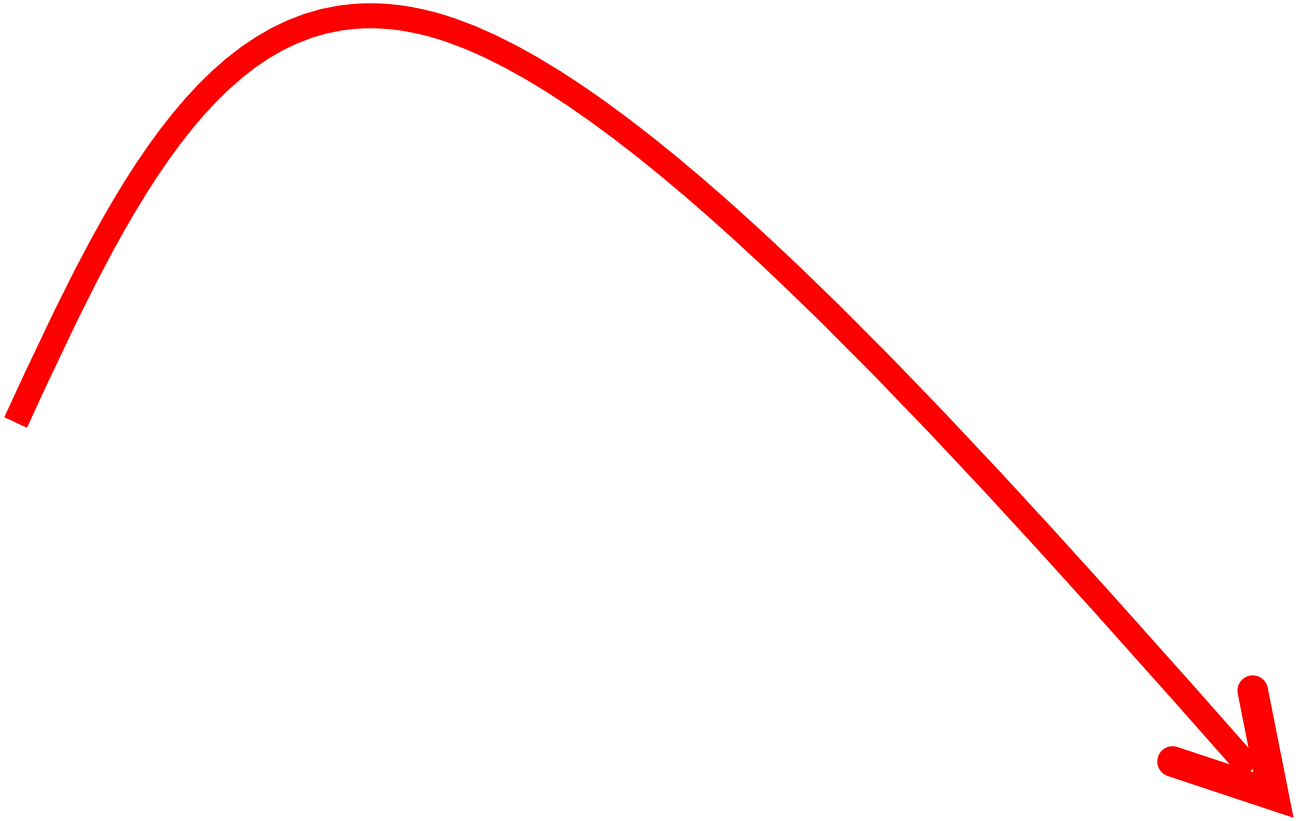
5,000

6,000

$AS(W_1)$

P1

Potential GDP



Recessionary Gap

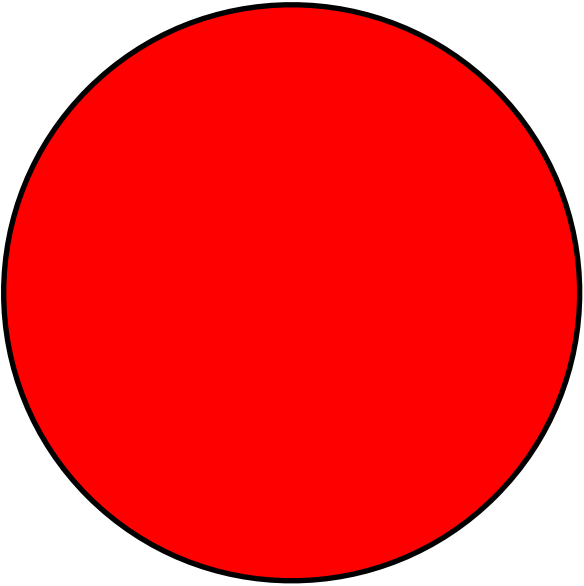
$$AS(W_2)$$

Unemployment: workers willing to accept pay cut, easier for firms to decrease wages

Wages fall AS shifts right

As prices fall, Aggregate Demand increases: gap closes

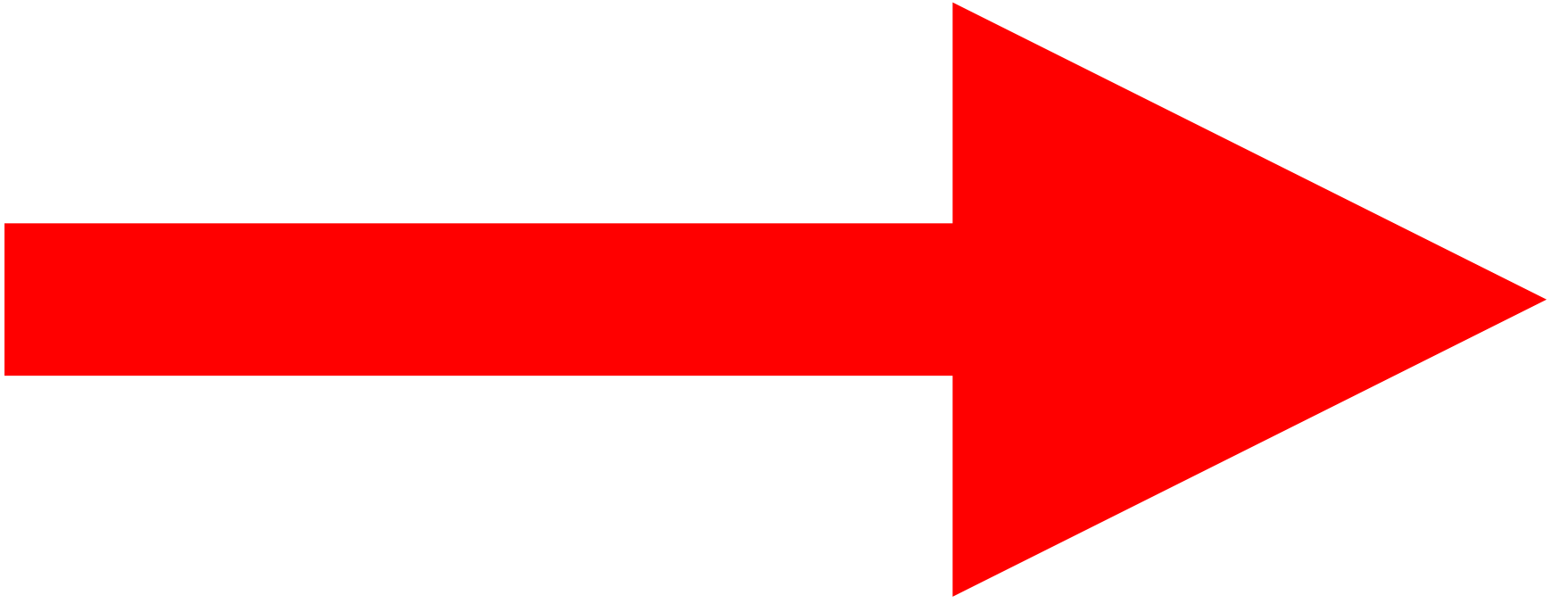
Weak Demand is eliminated by the decrease in prices

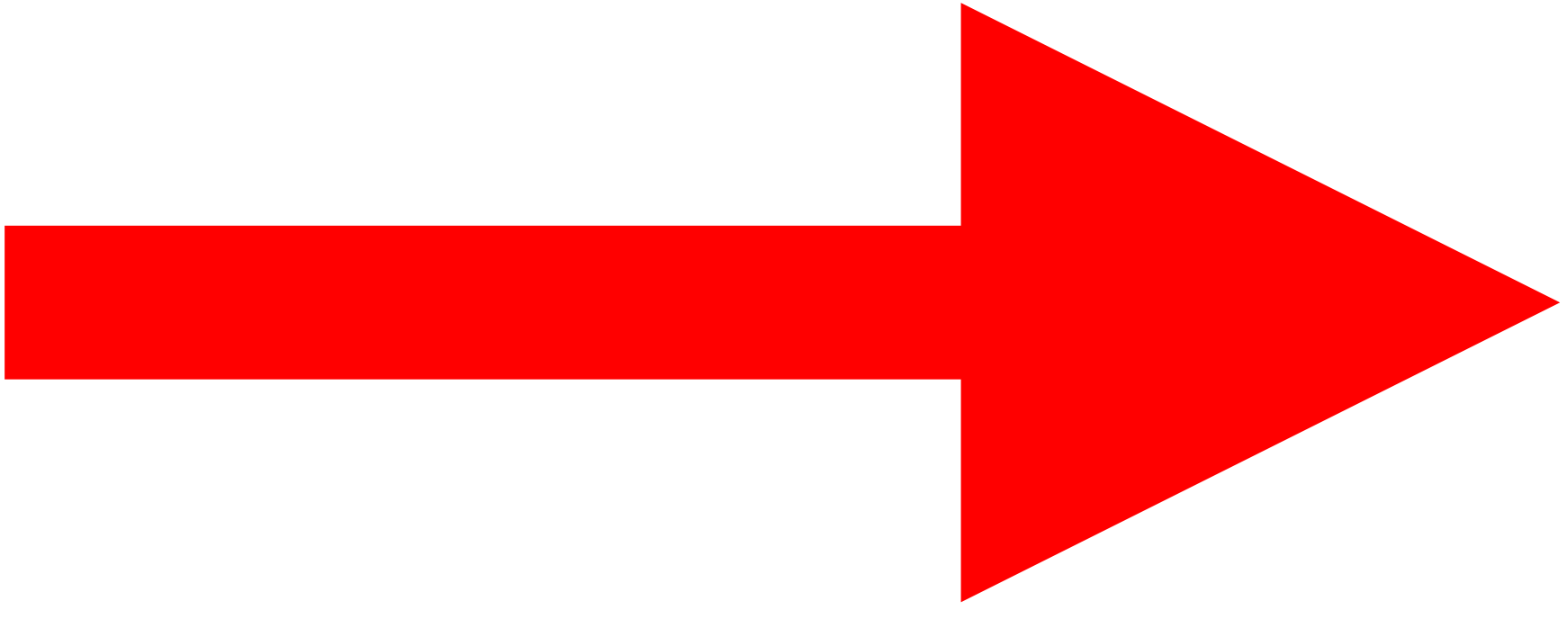


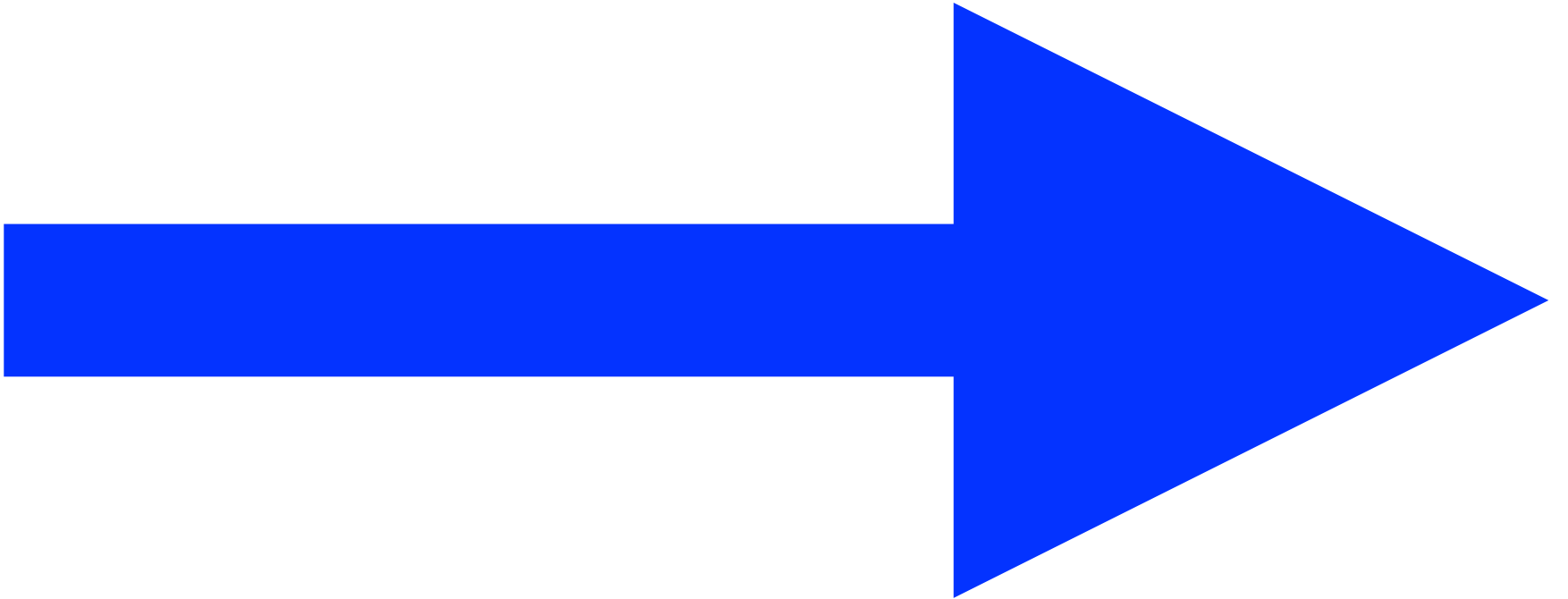
Unemployment cause wages to fall

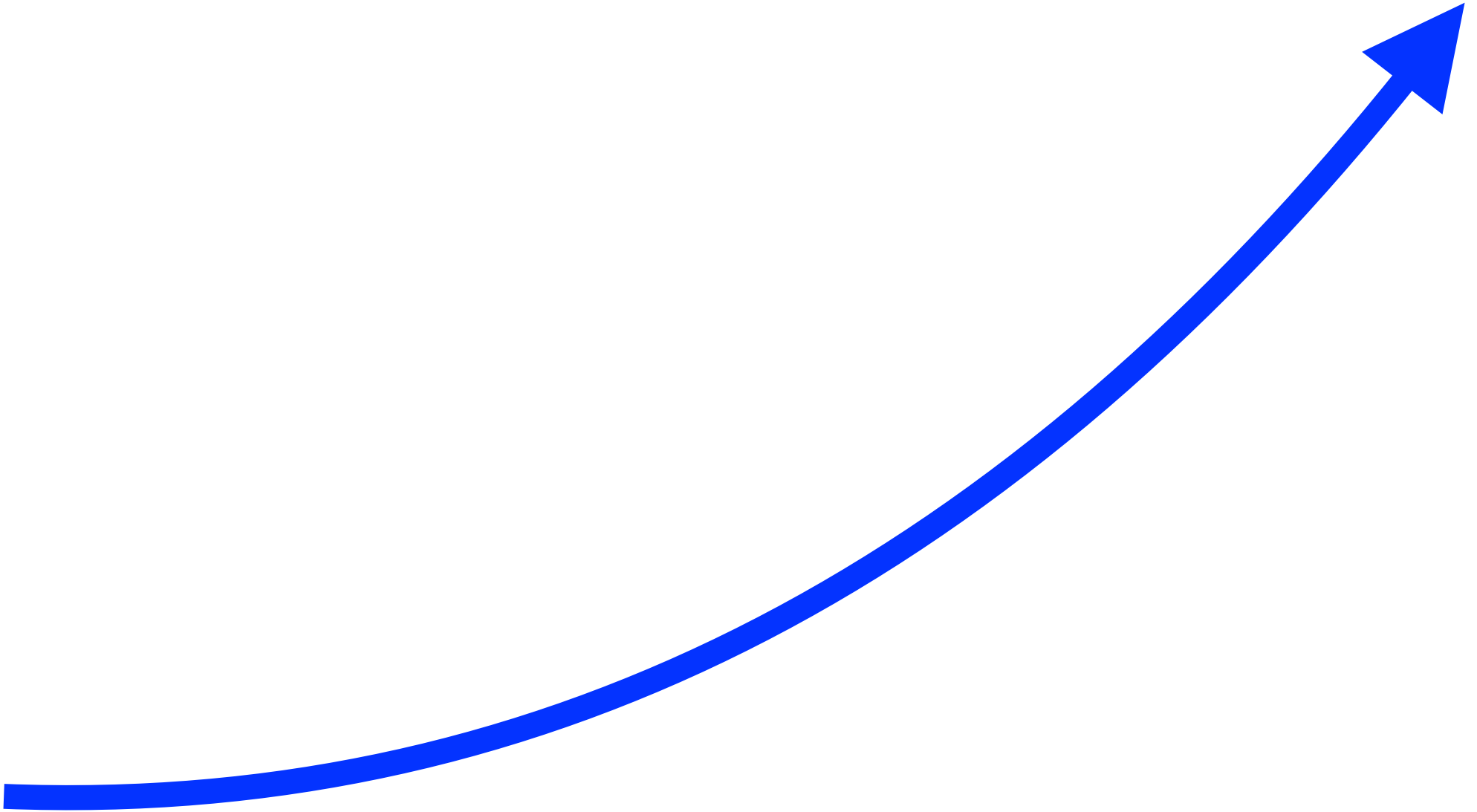
and then, prices fall

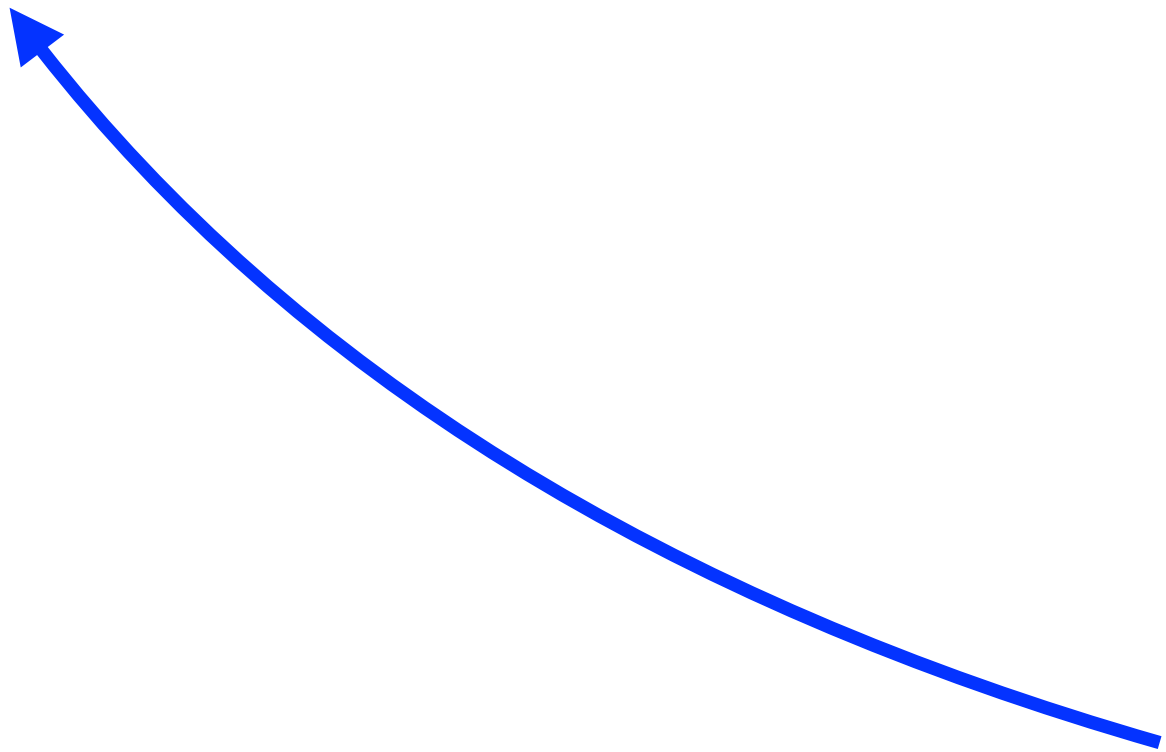
Weak Demand

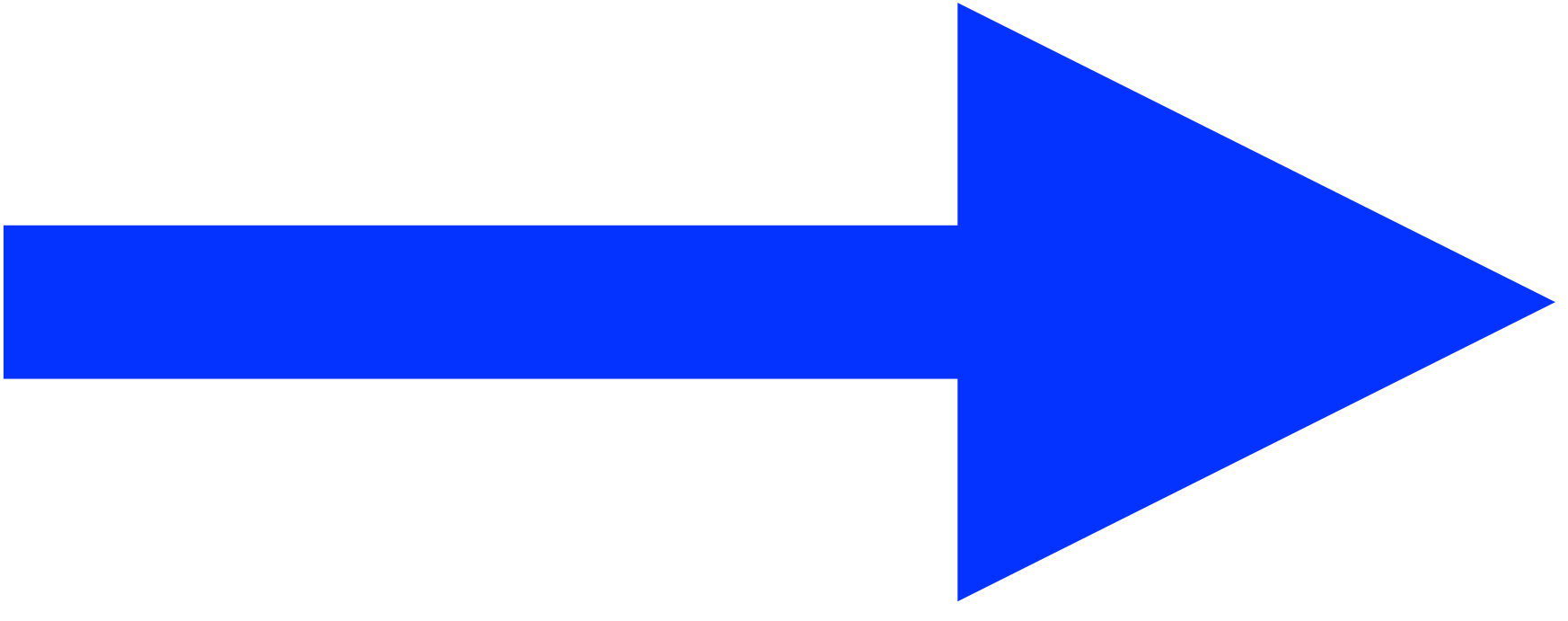












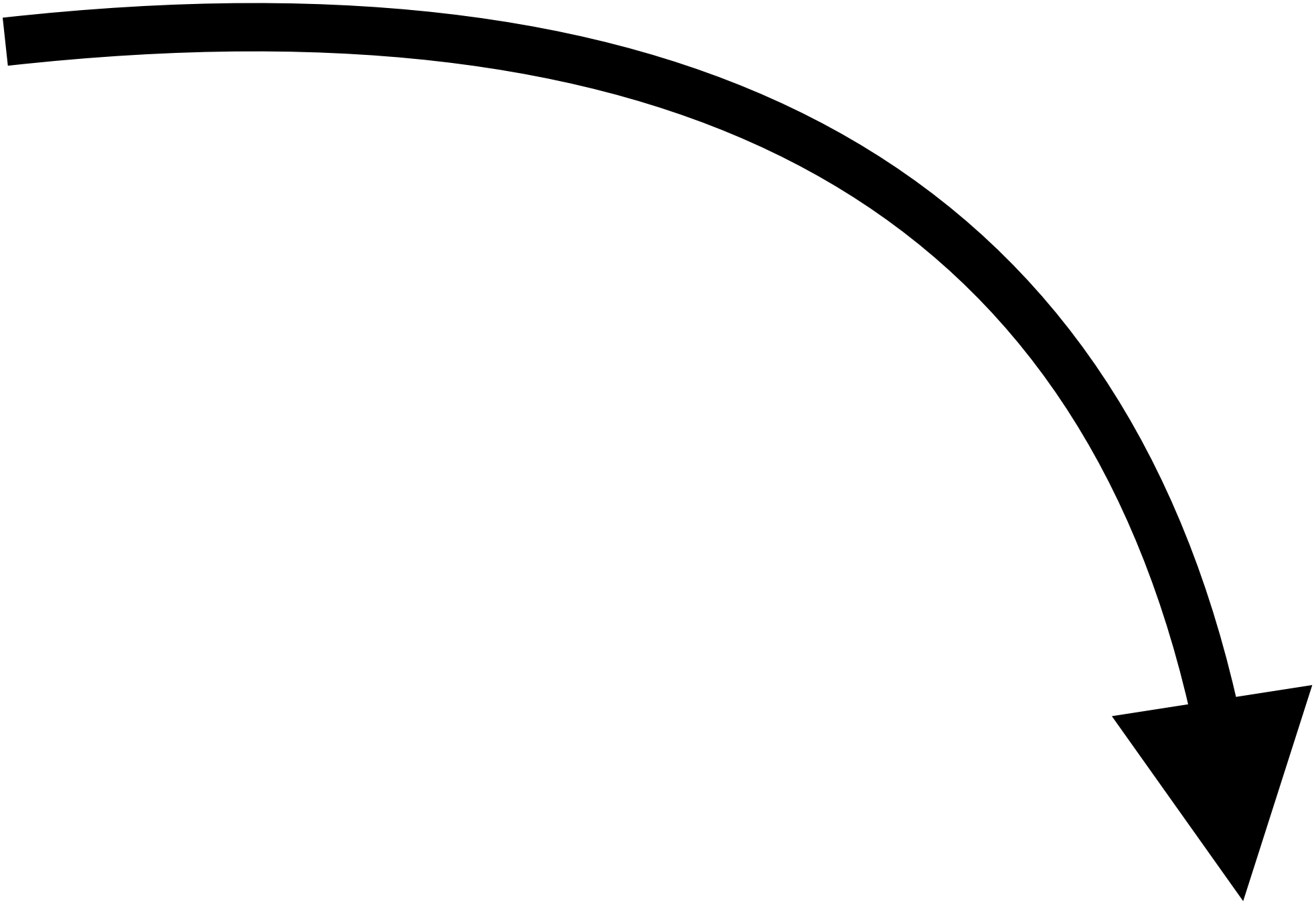
The Self Adjusting Mechanism works through automatic changes in wages and prices

1

2

3

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



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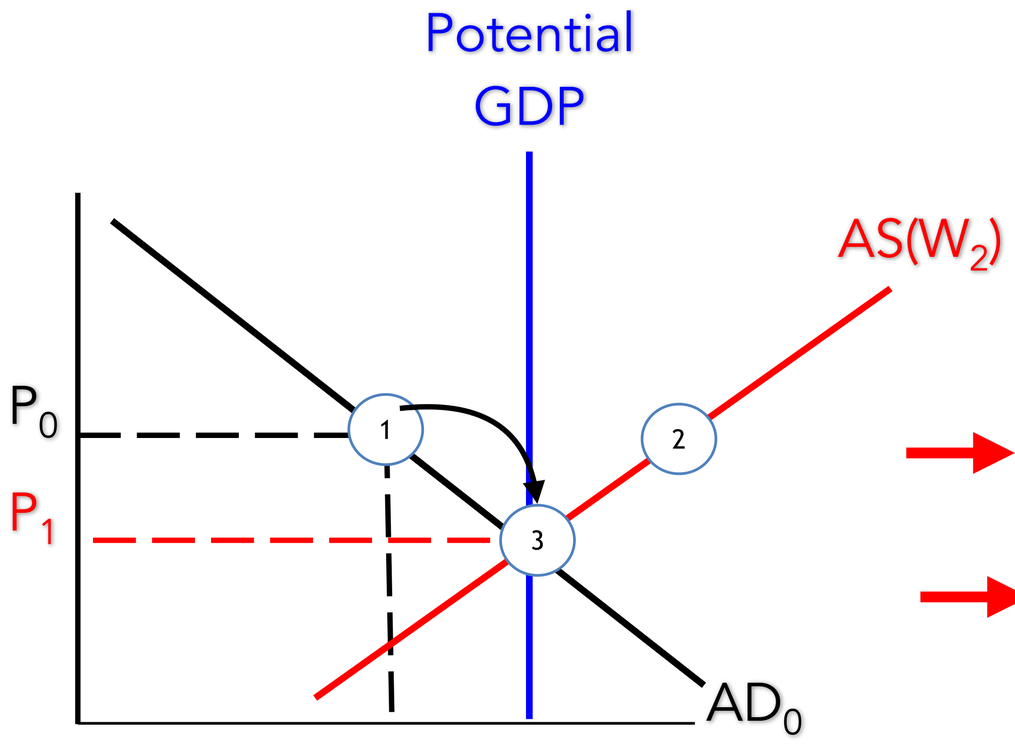

As prices fall, Aggregate Demand increases: gap closes

Weak Demand → Weak Demand is eliminated by the decrease in prices

Unemployment: workers willing to accept pay cut, easier for firms to decrease wages → Wages fall AS shifts right

Unemployment cause wages to fall and then, prices fall

Does the US economy has a self correcting mechanism?