Chapter 8, The Self-Regulating Economy

I. Classical Economics
   A. Older: Adam Smith, David Ricardo, Thomas Malthus, John Stuart Mill, Alfred Marshall
   B. Modern: Neo-Classical, Monetarists
   C. Resource Markets
      1. Labor markets
         a. Downward sloping demand (employers), upward sloping supply (workers)
         b. Equilibrium wage rates
         c. Difficult times (recession) led to layoffs and unemployment, and unemployed workers went elsewhere, sometimes displacing higher wage workers
         d. Boom times (expansion) led to increased employment and tight labor markets, and workers could easily move to higher wage positions.
      2. Interest rates: credit markets ("loanable funds")
         a. Downward sloping demand (investors), upward sloping supply (savings)
         b. Equilibrium rates of interest
         c. Increase in savings led to decrease in interest rates; it also led to an equal decrease in consumption, but Total Expenditures remained unchanged as businesses increased their investment levels correspondingly.
         d. Decrease in savings led to increase in interest rates and reverse of above.
      3. Bottom line: FLEXIBILITY in returns to owners of resources in resource markets
      4. Same outcome for product markets: prices move according to demand/supply.

II. Real GDP and "Natural RGDP" (Full employment RGDP)
   A. Three possibilities
      1. RGDP = Natural RGDP: Equilibrium RGDP
      2. RGDP < Natural RGDP: Recessionary gap (think, Aggregate Demand is deficient)
      3. RGDP > Natural RGDP: Inflationary gap (think, Aggregate Demand is excessive)
   B. The Self-Regulating Economy
      1. What if RGDP < Natural RGDP (a Recessionary gap)?key
         a. With unemployment higher than the natural rate of unemployment, as new contracts are negotiated employers will be able to negotiate lower wage rates, shifting SRAS to the right to LRAS
         b. Prices will drop and the recessionary gap will be eliminated.
      2. What if RGDP > Natural RGDP (a Recessionary gap)?key
         a. With unemployment lower than the natural rate of unemployment, as new contracts are negotiated employers will be forced to pay higher wage rates, shifting SRAS to the left to LRAS
         b. Prices will rise and the inflationary gap will be eliminated.

III. Policy Implications
   A. "Laissez Faire": Let the market alone!
   B. If the economy is on LRAS, a change in AD will result in an "opposite" shift in SRAS to the LRAS function, and will result in price changes only.
      1. Increase in AD will lead to decrease in AS and higher prices.
      2. Decrease in AD will lead to increase in AS and lower prices.