Short Run

Aggregate Supply

Price Level

GDP Produced in the short run (while wages are constant)

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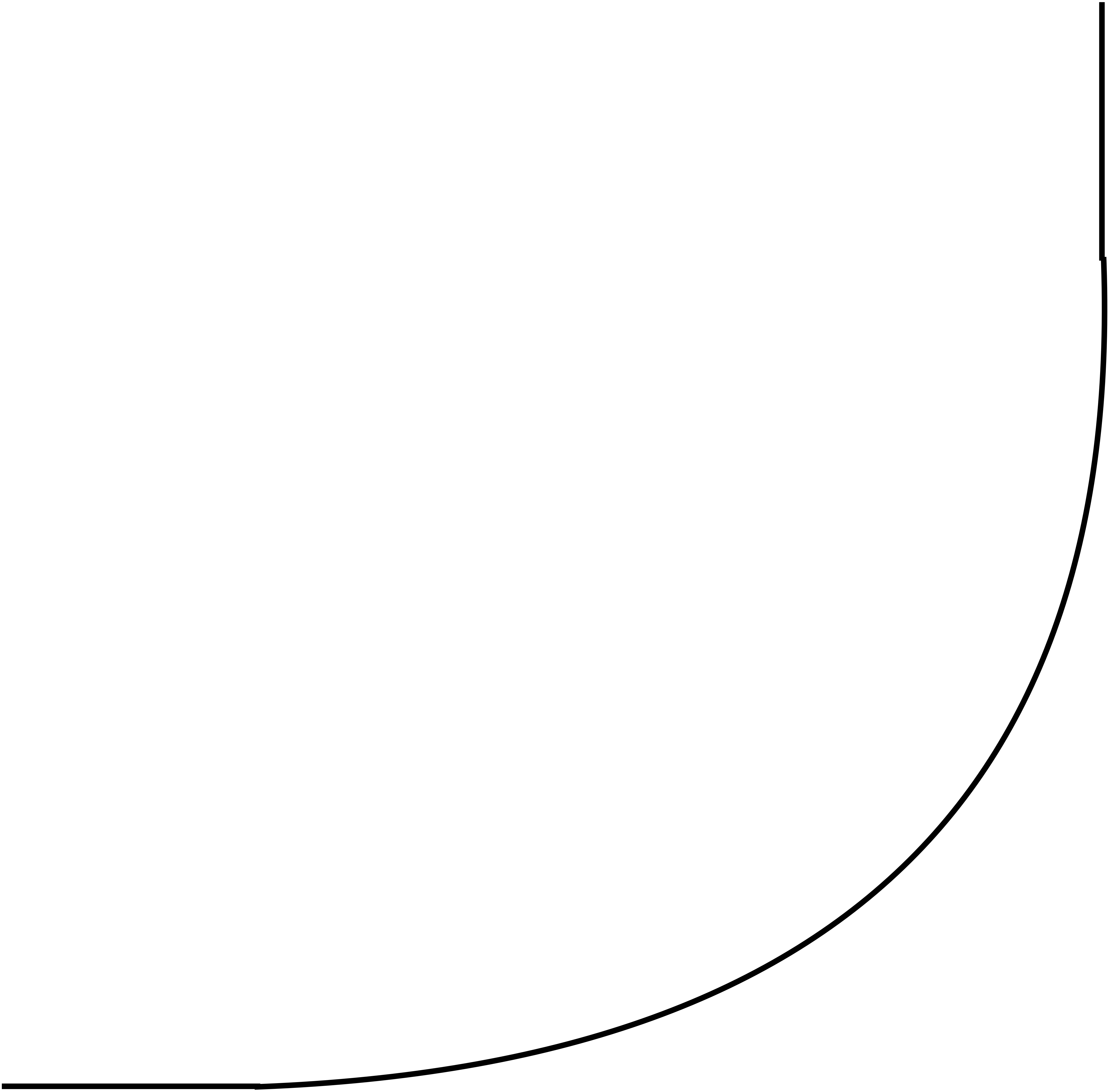
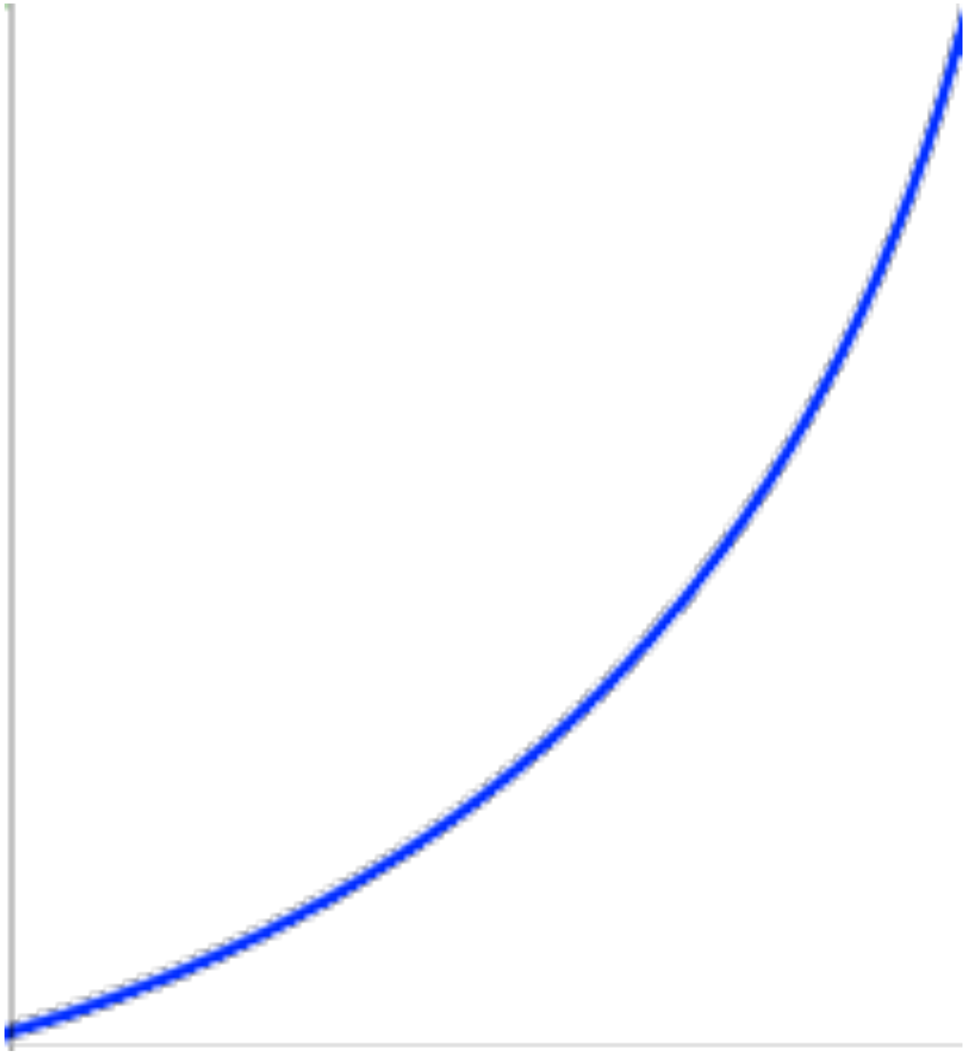


At Potential GDP

Very low GDP
(a Recession)

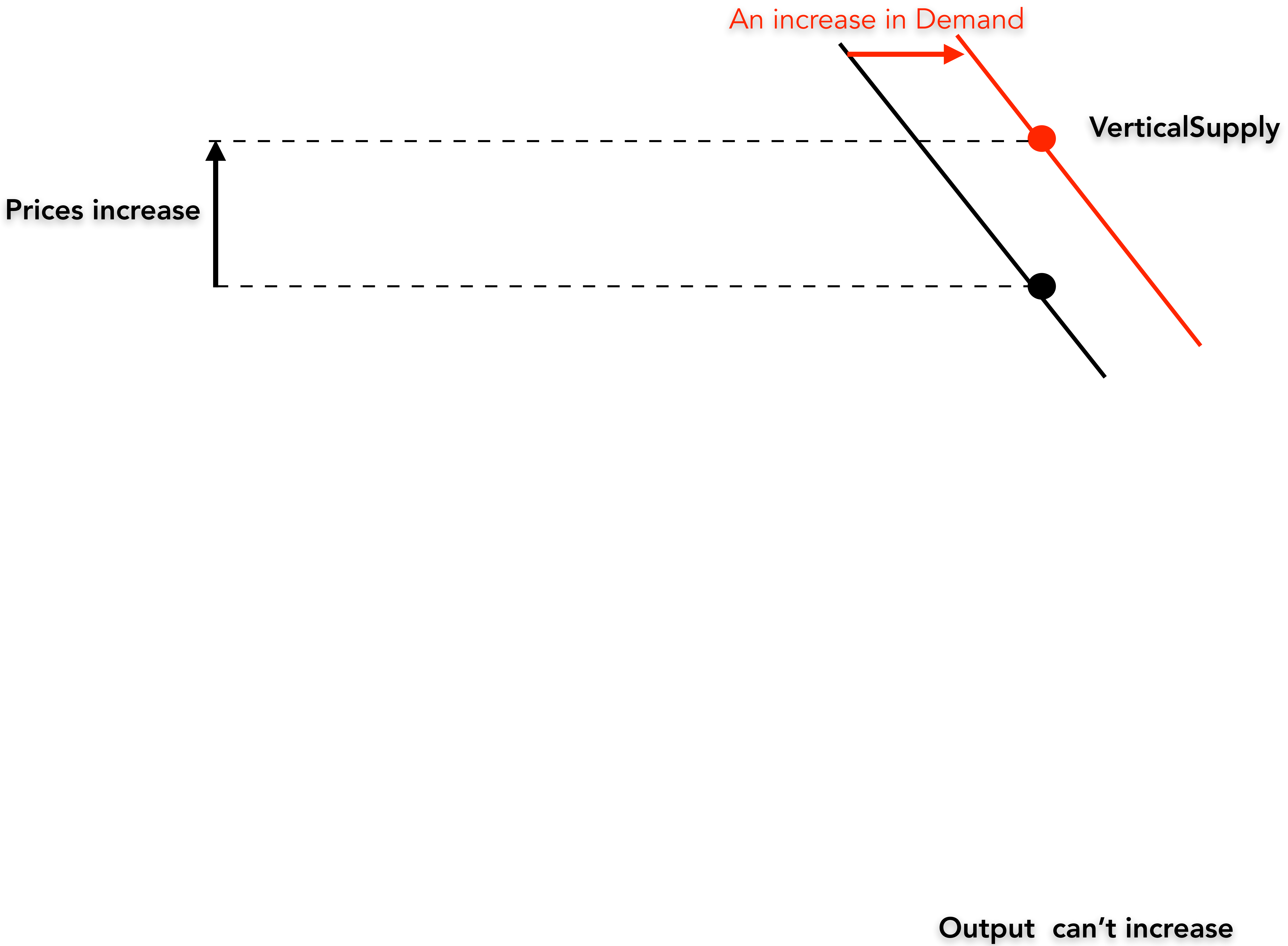


Below Potential GDP

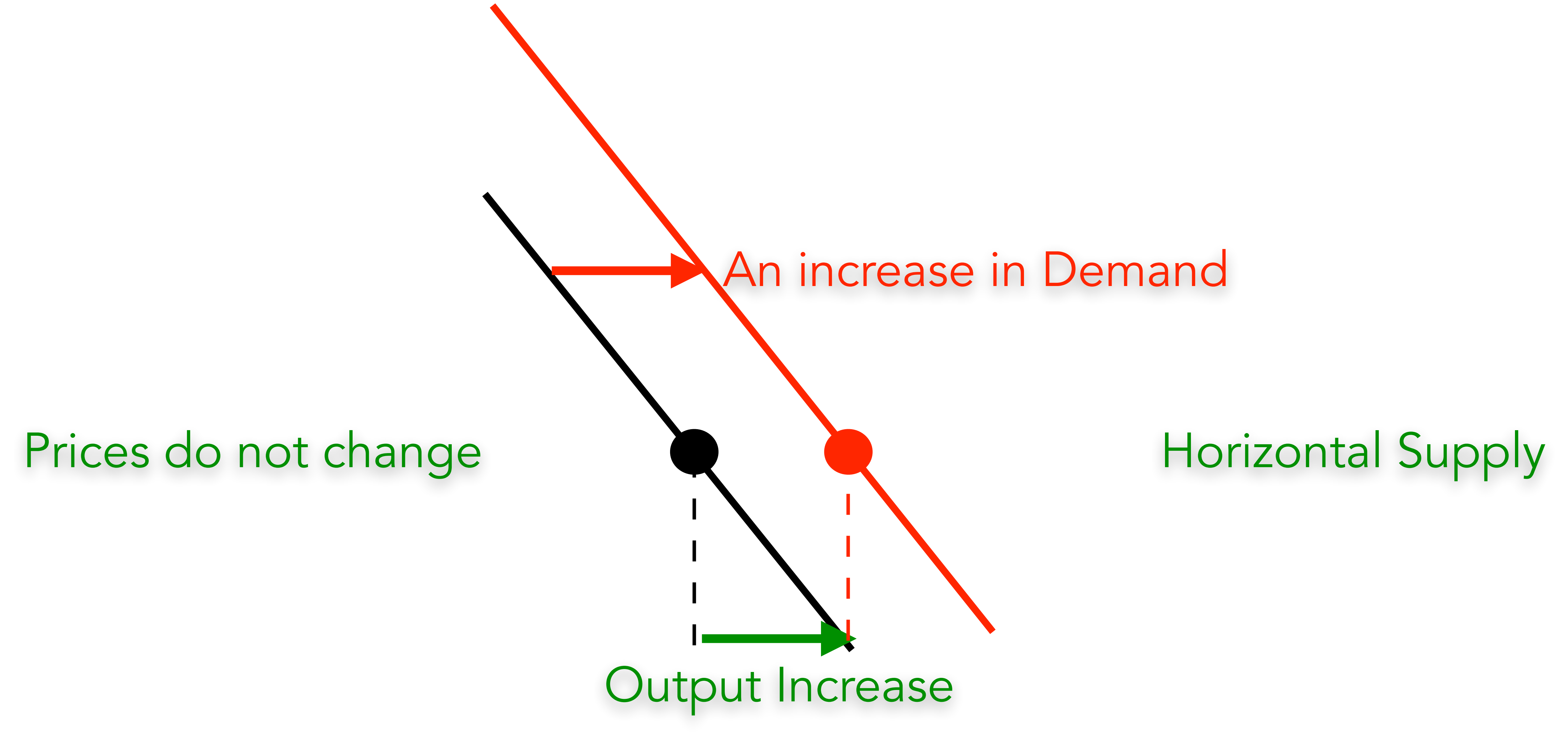
Supply is vertical: firms increase prices but can't increase output

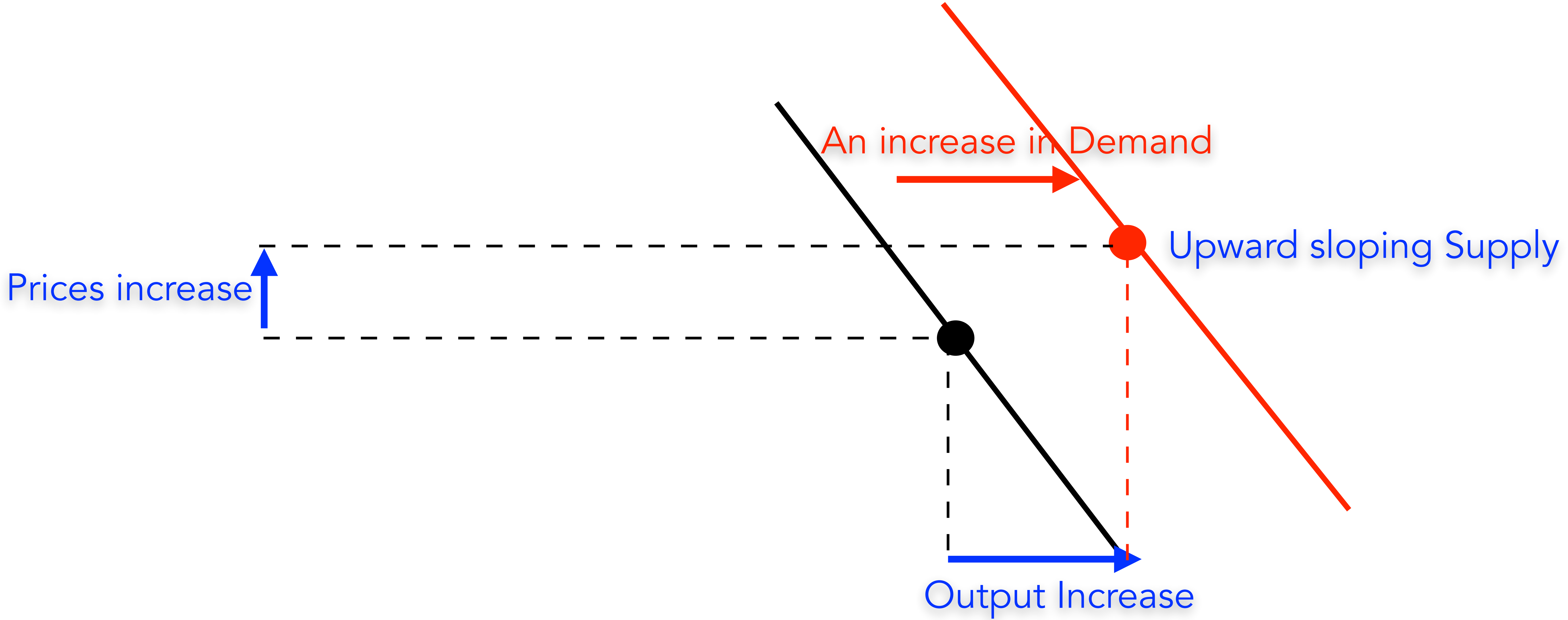
Supply is upward sloping: firms raise both prices and output

How firms react to an increase in Aggregate Demand depends on where the Economy is...



An increase in Demand
VerticalSupply
Prices increase
Output can’t increase


An increase in Demand
Prices do not change
Horizontal Supply
Output Increase

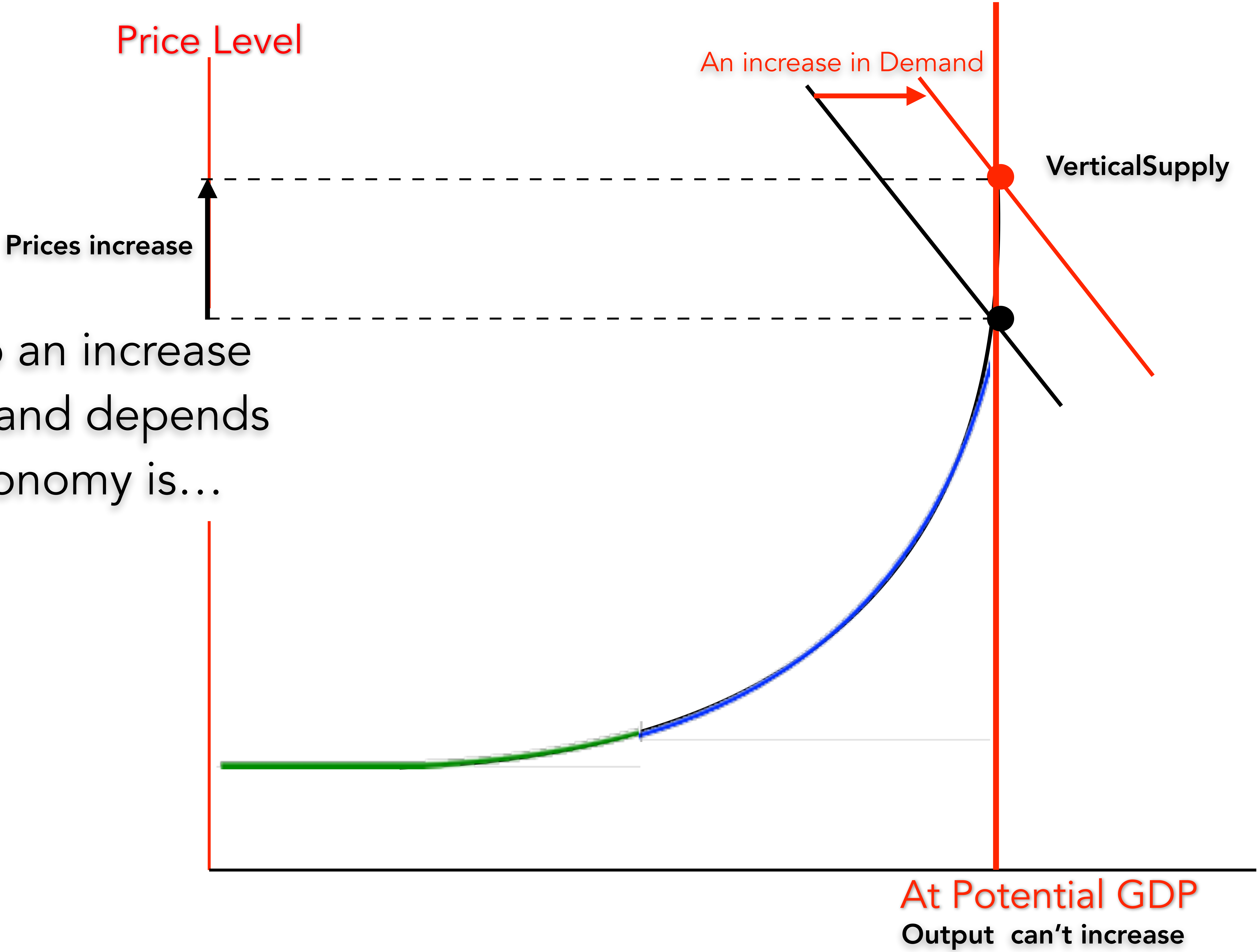


An increase in Demand
Upward sloping Supply
Prices increase
Output Increase

Supply is horizontal: firms increase output but can't raise prices

$SRAS(Wages_{fixed})$

How firms react to an increase in Aggregate Demand depends on where the Economy is…



MPC = 0.75
An increase in G
ΔG = +70
45
AE1
AE0
AE1
ΔAE=280
ΔAD = 280
ΔG
AE0
ΔY=ΔG(1/(1-MPC))
ΔY =280
Y0
Y1
Price Level (CPI)
Po
AD0
GDPo