





AE0

GDP/Income





Total
Production

Total
Purchases



Inventories
fall

AE₁

Y

O



**Firms
increase
output**



If AE
increase

Y

1



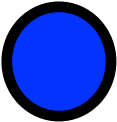
In fact, firms have **three** options when
Demand increase and sales are higher:

- Firms **increase output** and leave prices the same if they fear an increase in prices will depress sales: Likely reaction when the economy is producing **far below Potential GDP** (a recession)

- Firms **increase prices** and leave production the same if they have reached capacity and cannot produce more: Likely reaction when the economy is **at or near Potential GDP**

- Firms increase both prices and production:
Likely reaction when the economy is not yet
at Potential GDP

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- Firms **increase both prices and production**: Likely reaction when the economy is **not yet at Potential GDP**

