

AE_0

GDP_0

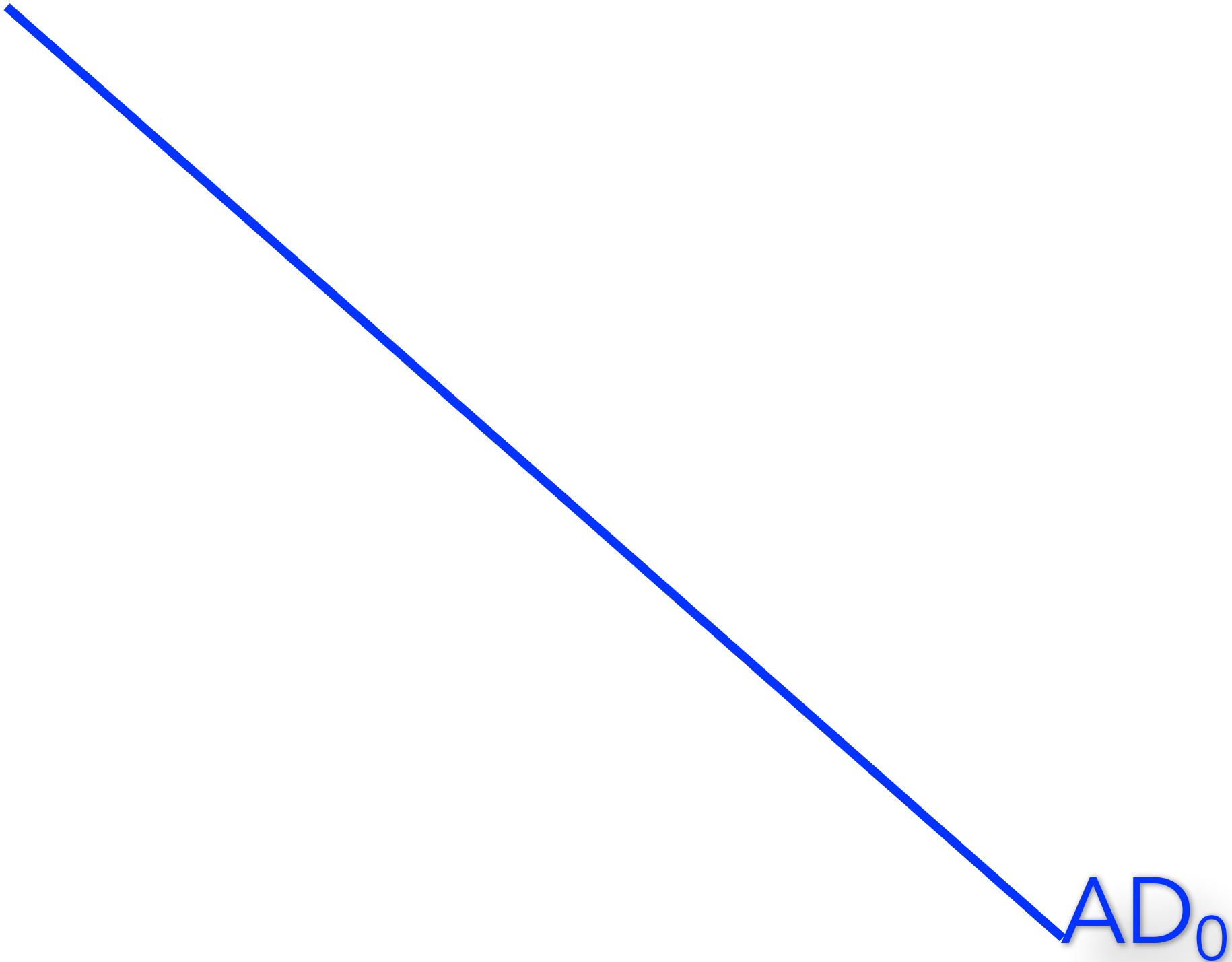
At Potential GDP



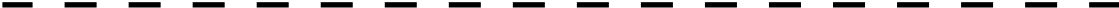
Price Level
(CPI)



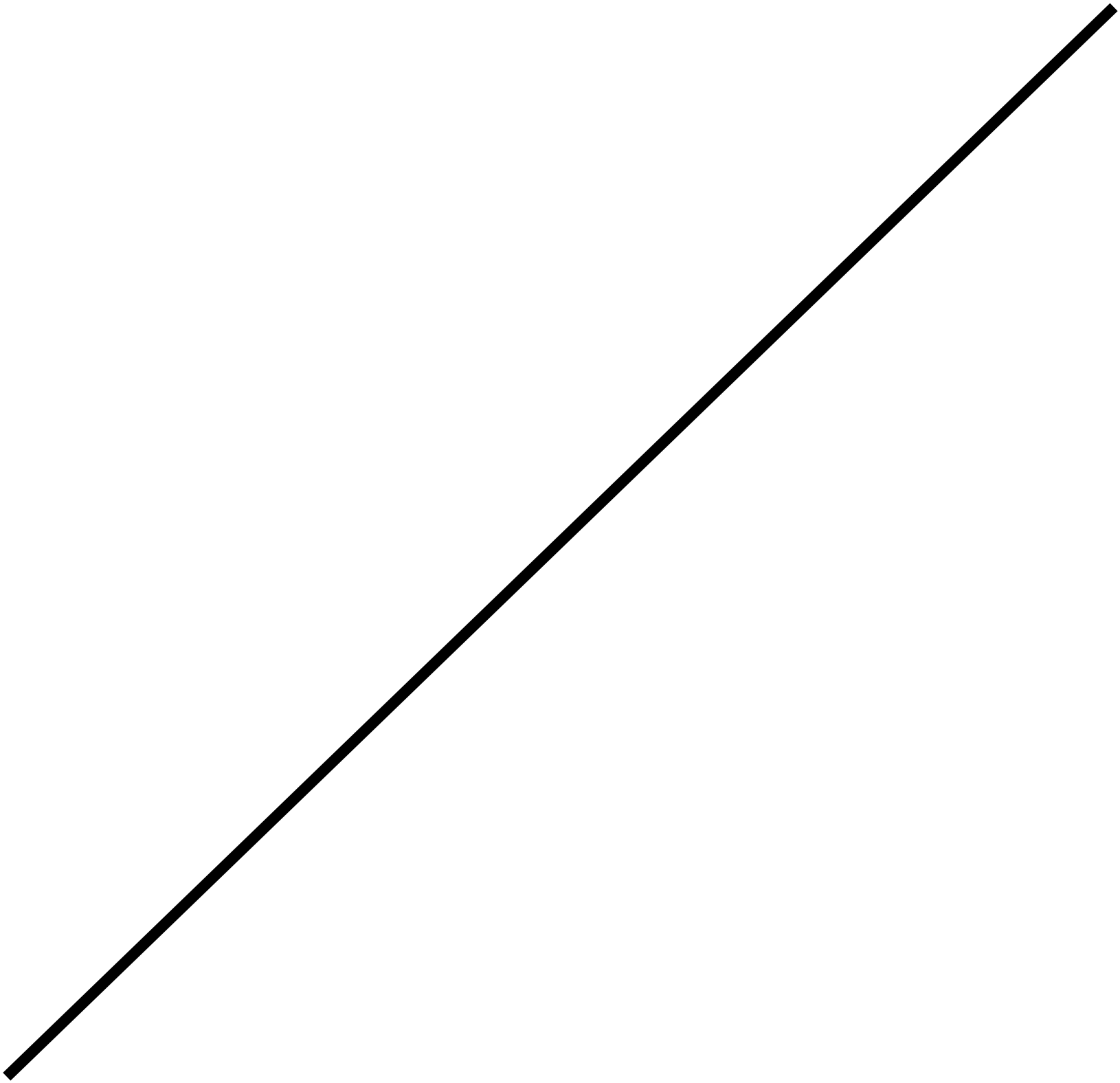




PO



AS₀



GDP₀

At Potential GDP

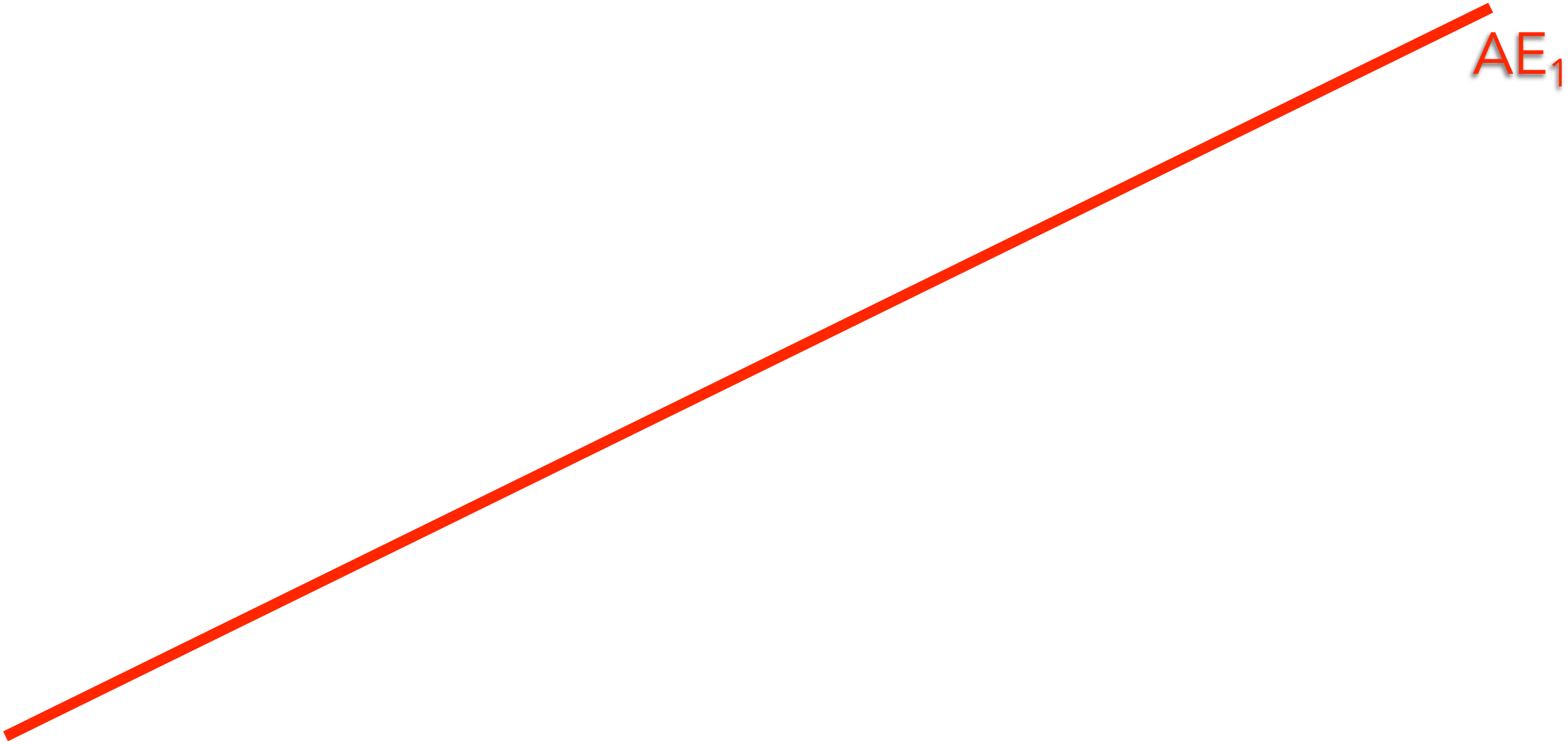


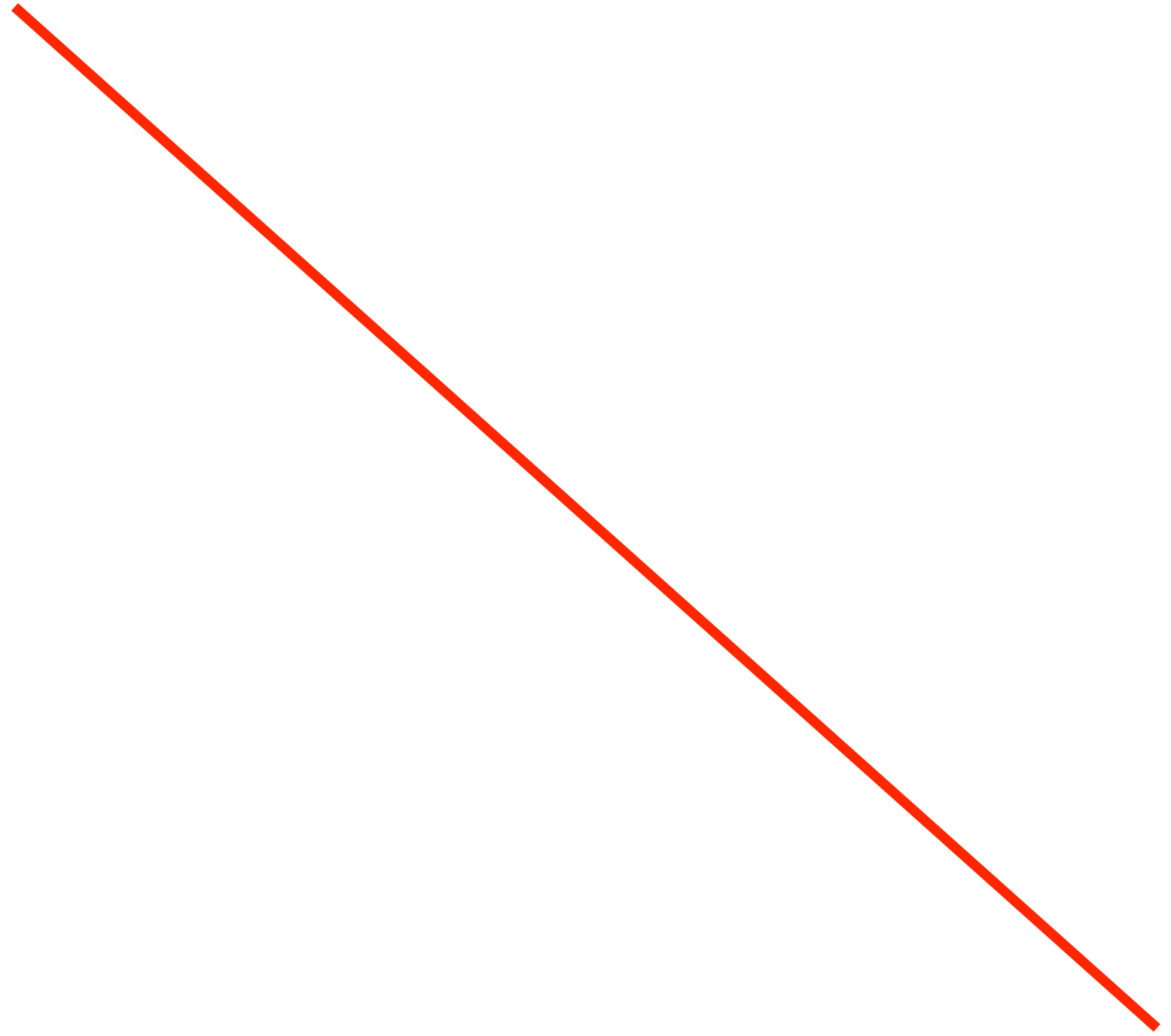
Inflationary Gap



Inflationary Gap

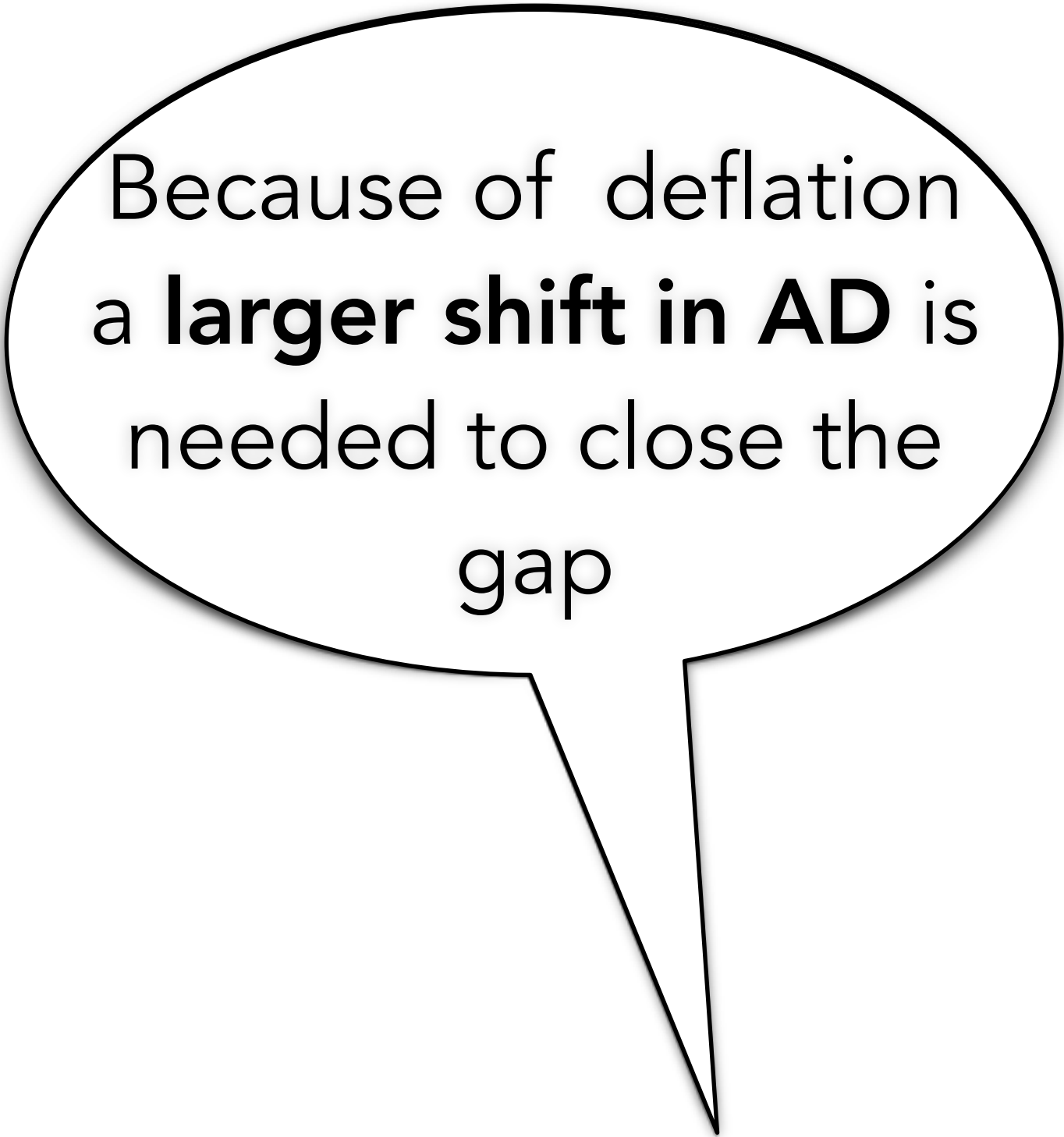




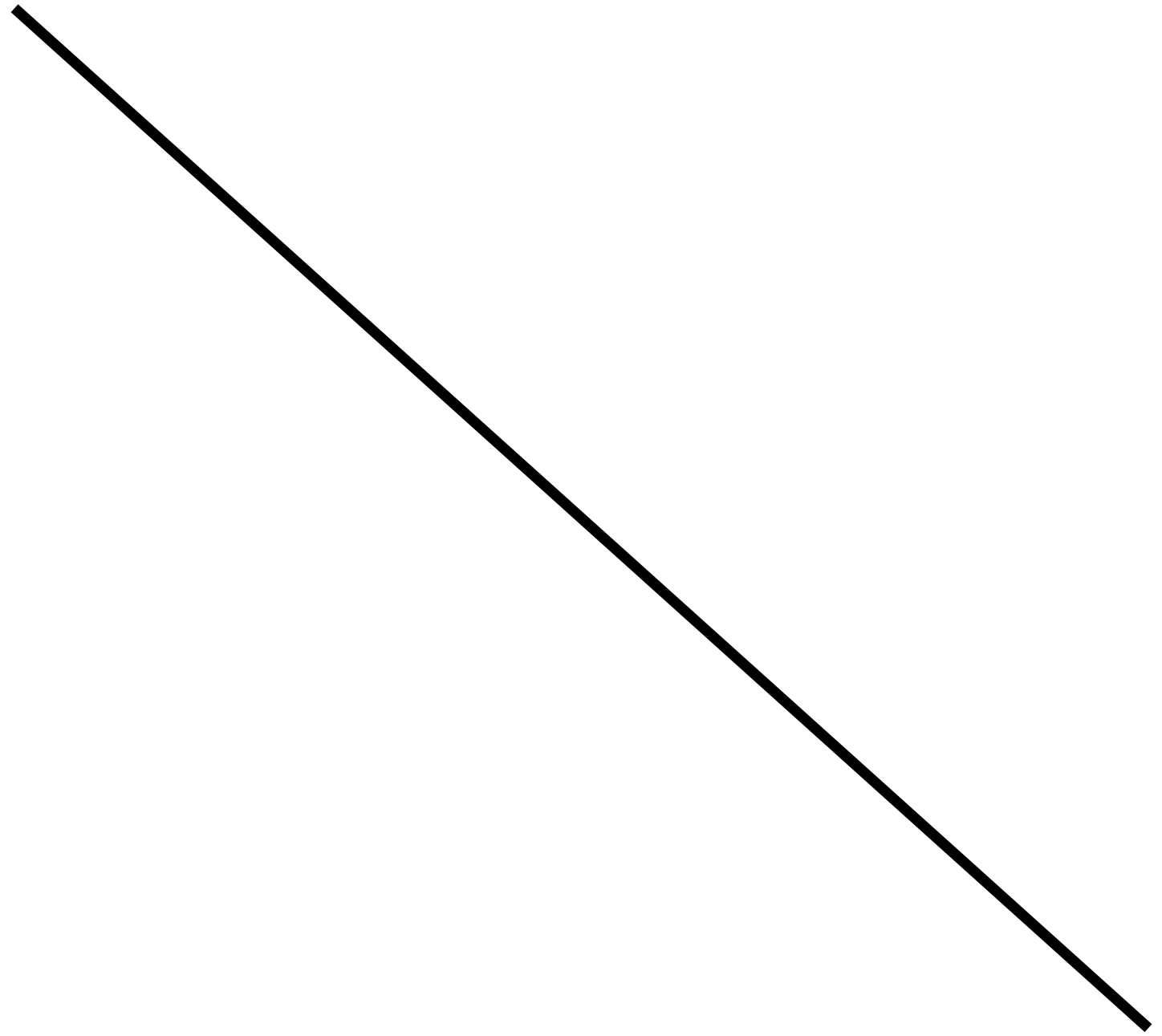


AD₁

Deflation **reduces** the size of the multiplier



Because of deflation
a **larger shift in AD** is
needed to close the
gap



AD₁



P₁



GDP₁

P₂

-

-

-

-

-

-

-

-

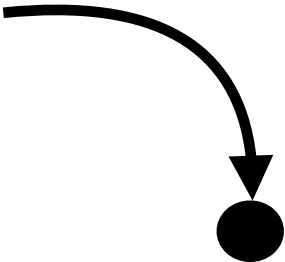
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GDP₂

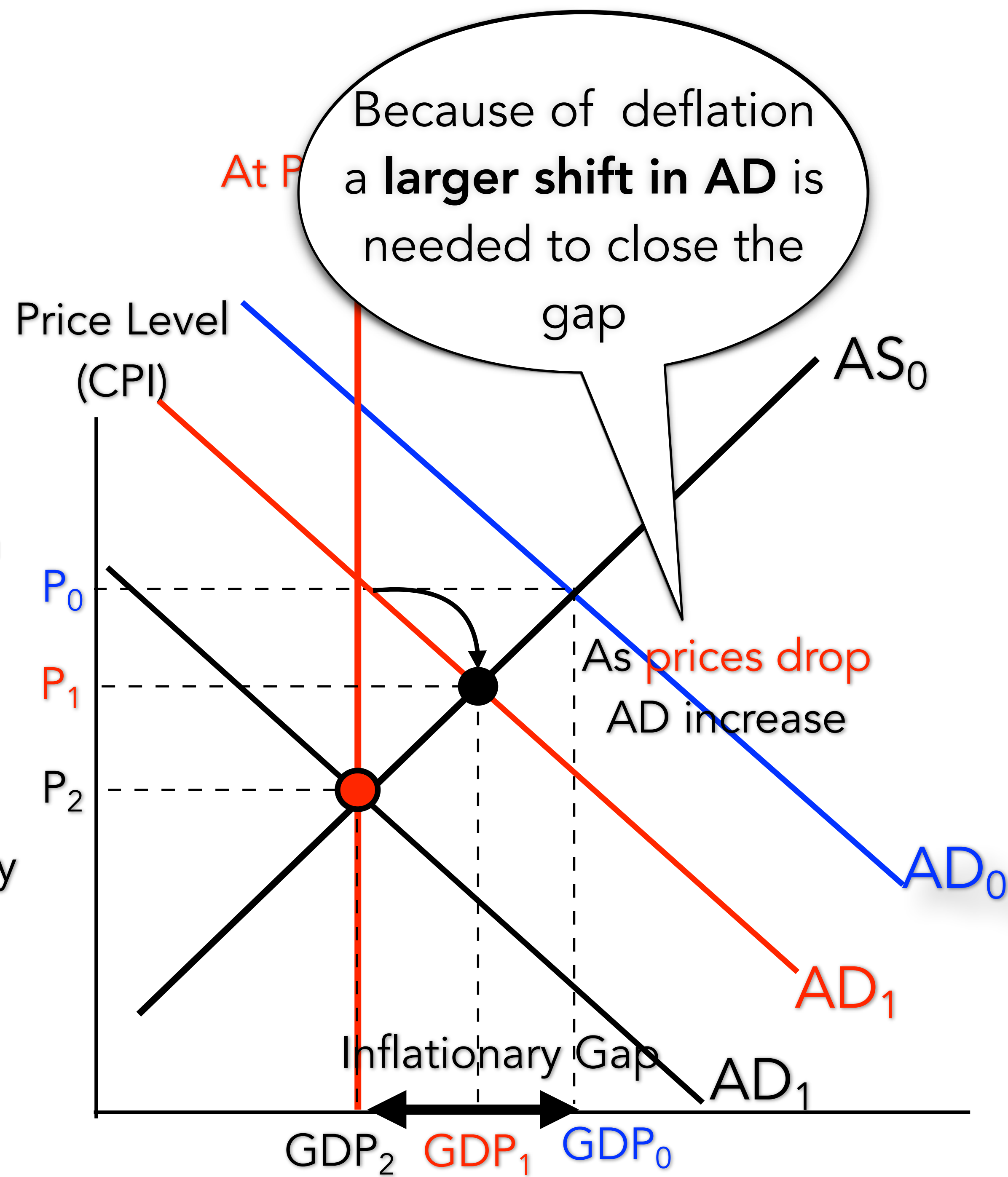
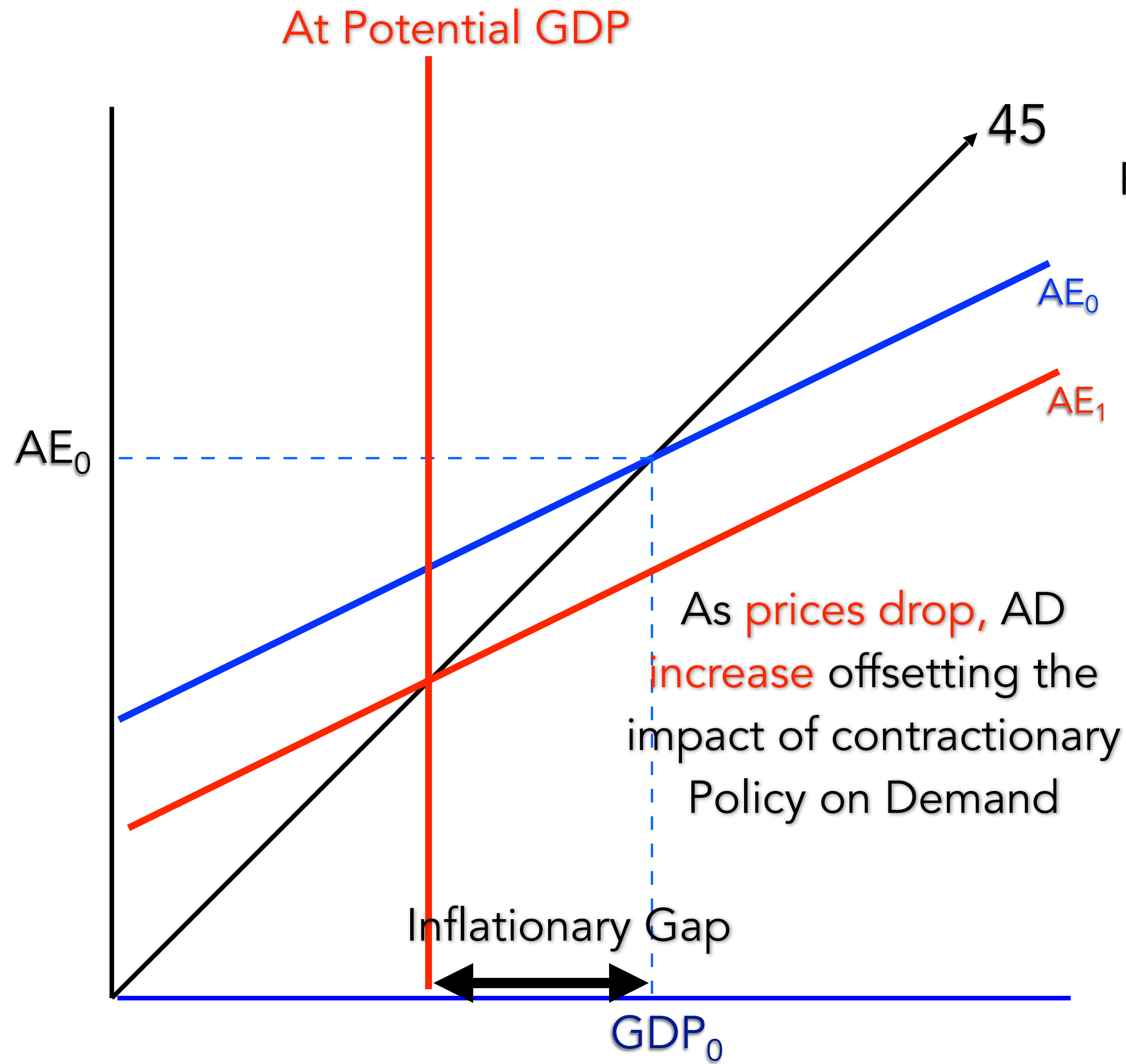


As prices drop, AD
increase offsetting the
impact of contractionary
Policy on Demand



As prices drop
AD increase

Deflation **reduces** the size of the multiplier



Stabilization policies are not needed