







**AEo**

GDP/Income





Total  
Production

Total  
Purchases



Inventories  
fall

AE<sub>1</sub>



Y

O



**Firms  
increase  
output**



If AE  
increase

Y<sub>1</sub>



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

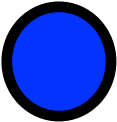
- Firms **increase output** and leave prices the same if they fear an increase in prices will depress sales: Likely reaction when the economy is producing **far below Potential GDP** (a recession)

- 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**

