















A large red arrow pointing to the left, with the text "Firms decrease output" written inside in white.

**Firms
decrease
output**





AE0

GDP/Incorne





Total

Production

Total
Purchases



Inventories
rise

AE₁

Y

O



If AE
decrease

Y₁



We need to **modify** the firm's reaction...

In fact, firms have **three** options when Demand decrease and sales are lower:

- Firms **decrease output** if they can't afford to drop prices below cost: Typical reaction when the economy is producing way **below Potential GDP** (a recession)

- Firms decrease prices and leave production the same: likely reaction when the economy is at Potential GDP

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

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

