

AE_0

GDP_0

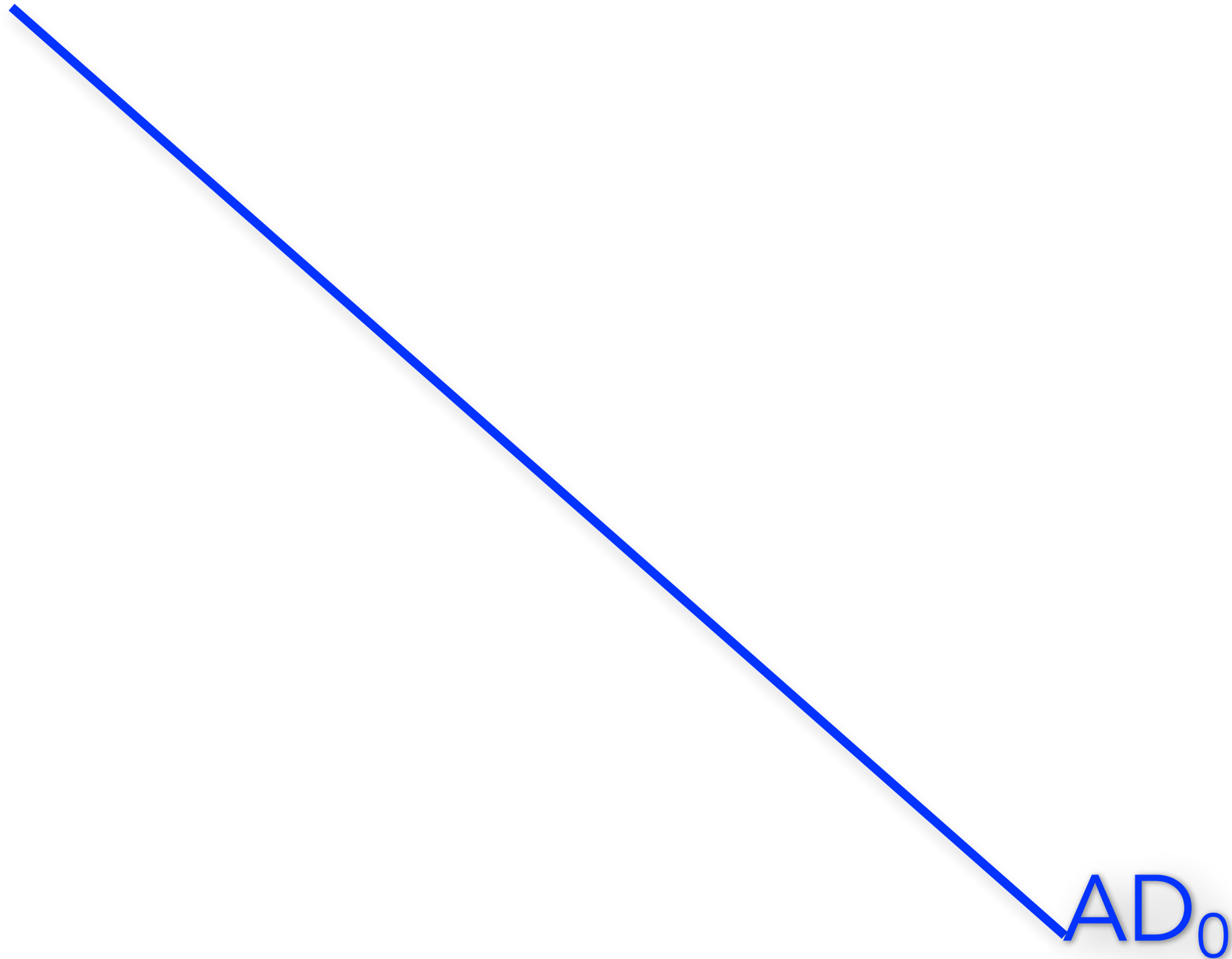
At Potential GDP



Price Level
(CPI)







P_0

—

—

—

—

—

—

—

—

—

—

—

—

—

—

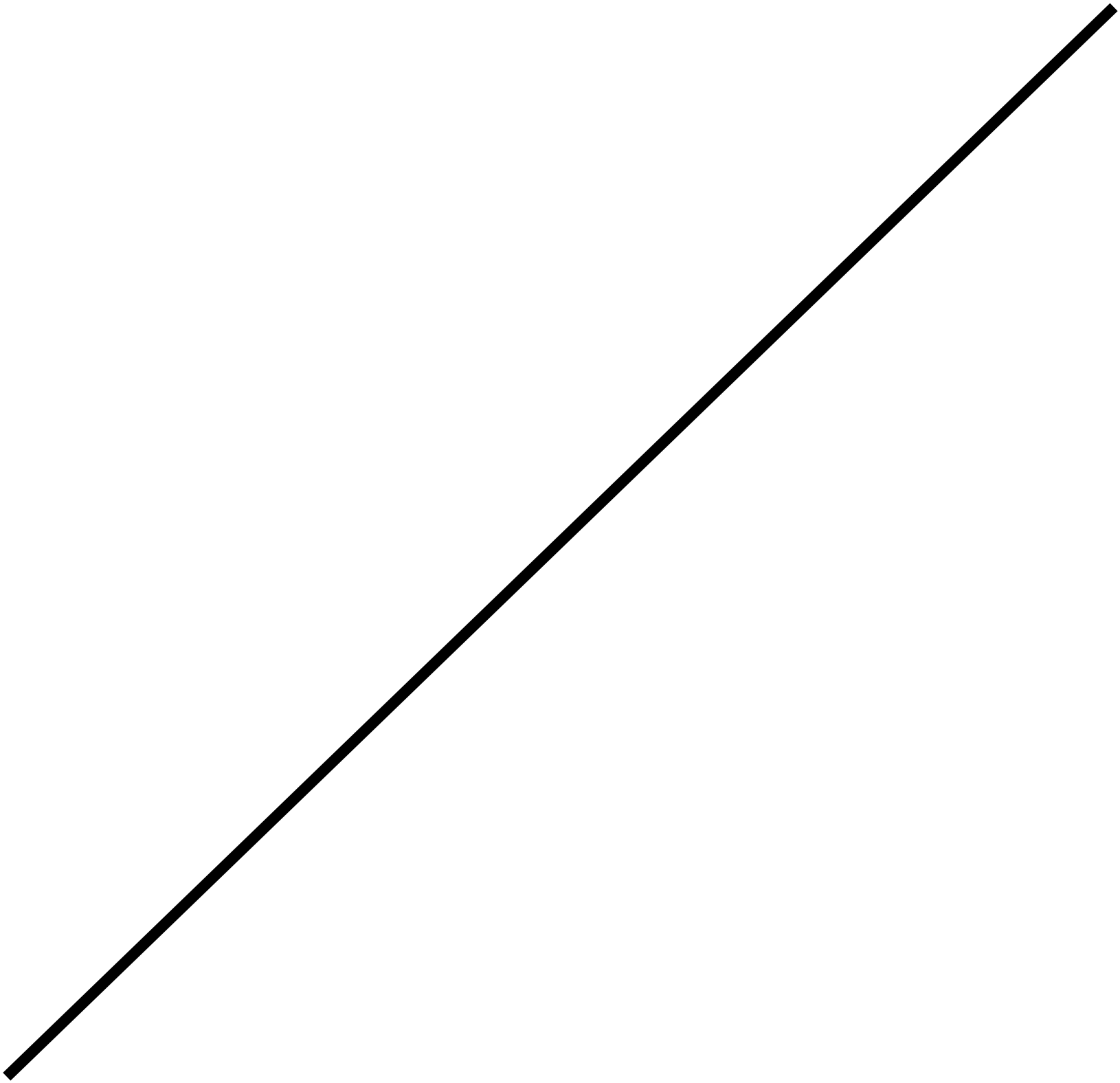
—

—

—

—

AS₀



GDP₀

At Potential GDP

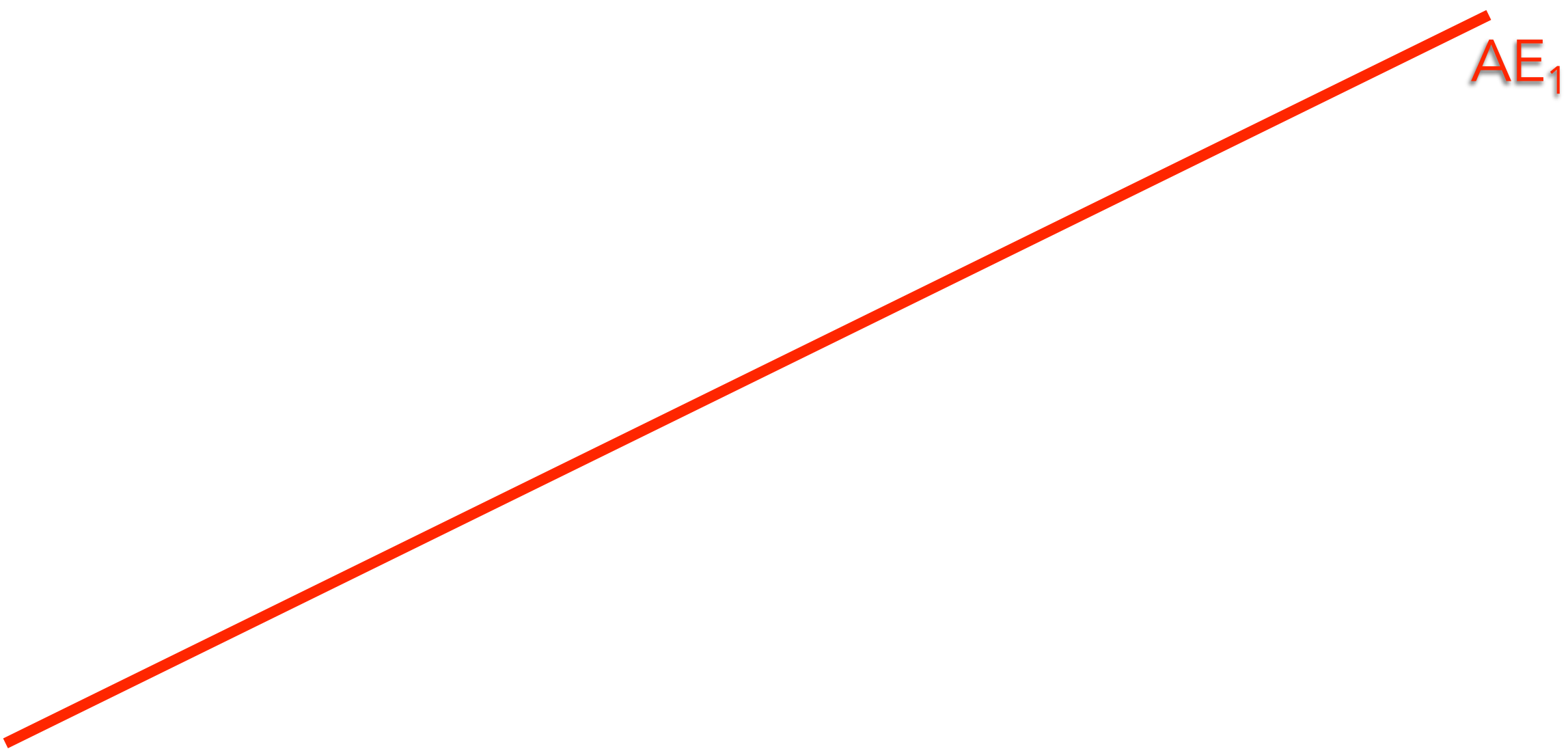


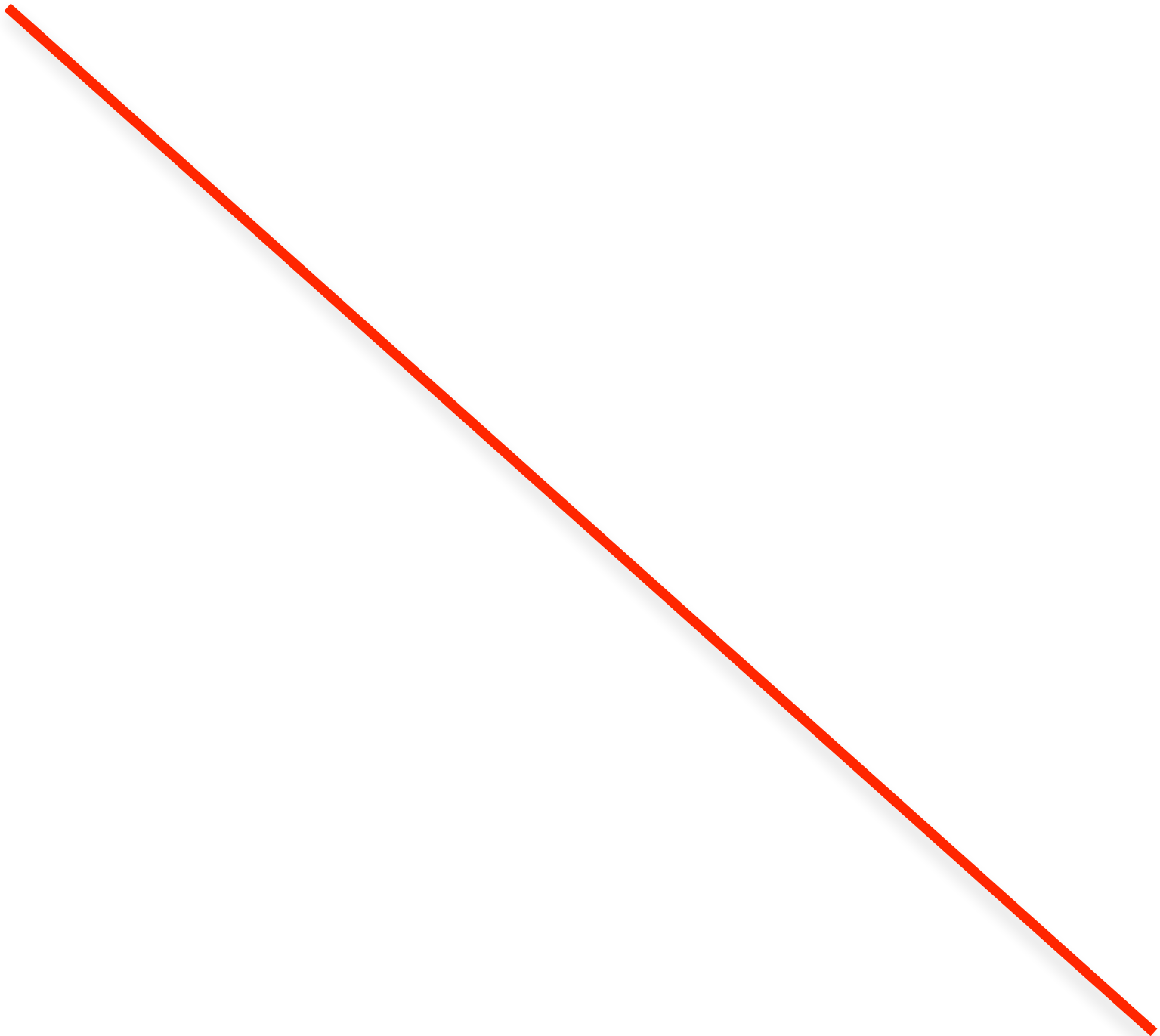
Inflationary Gap



Inflationary Gap

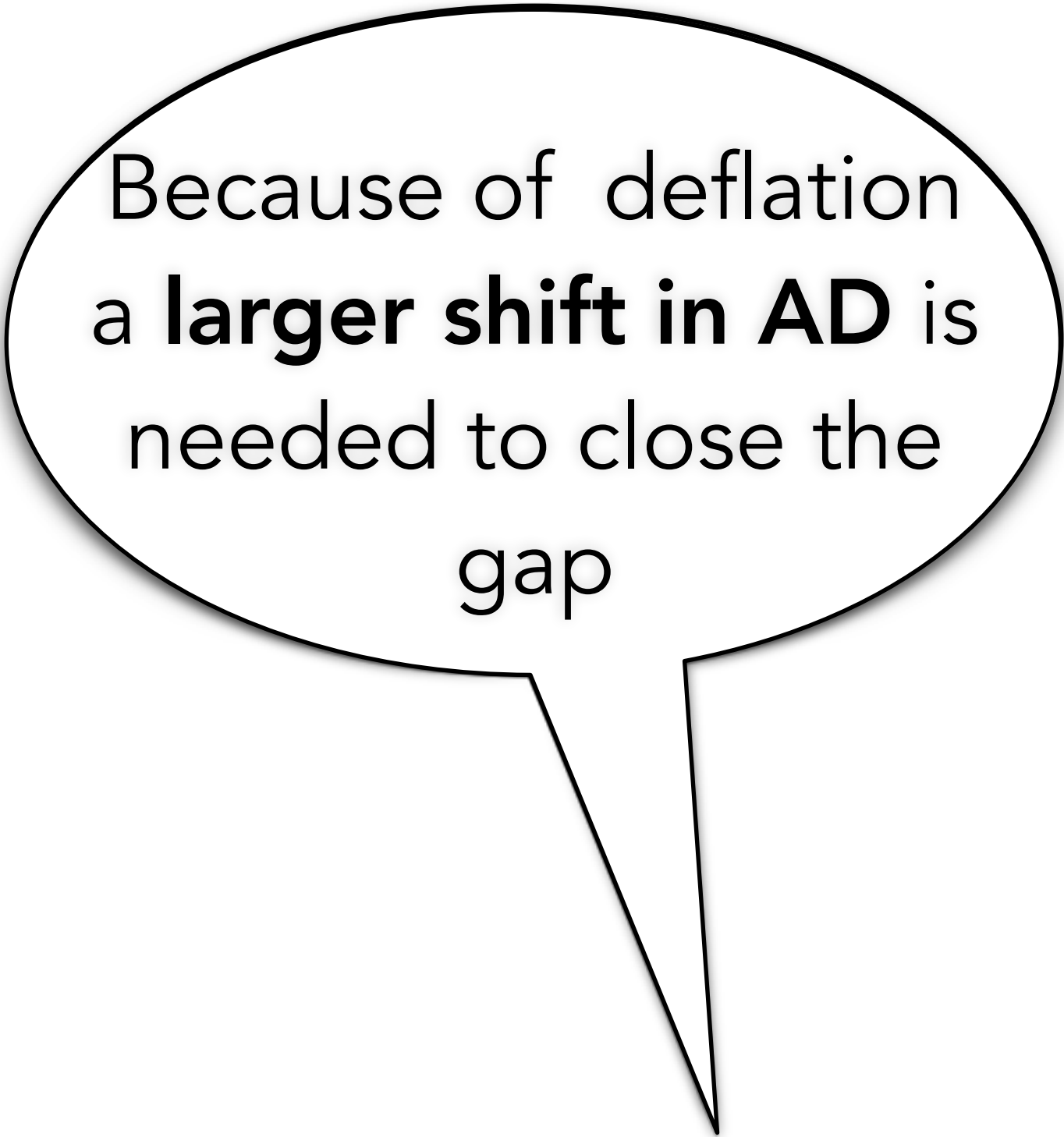




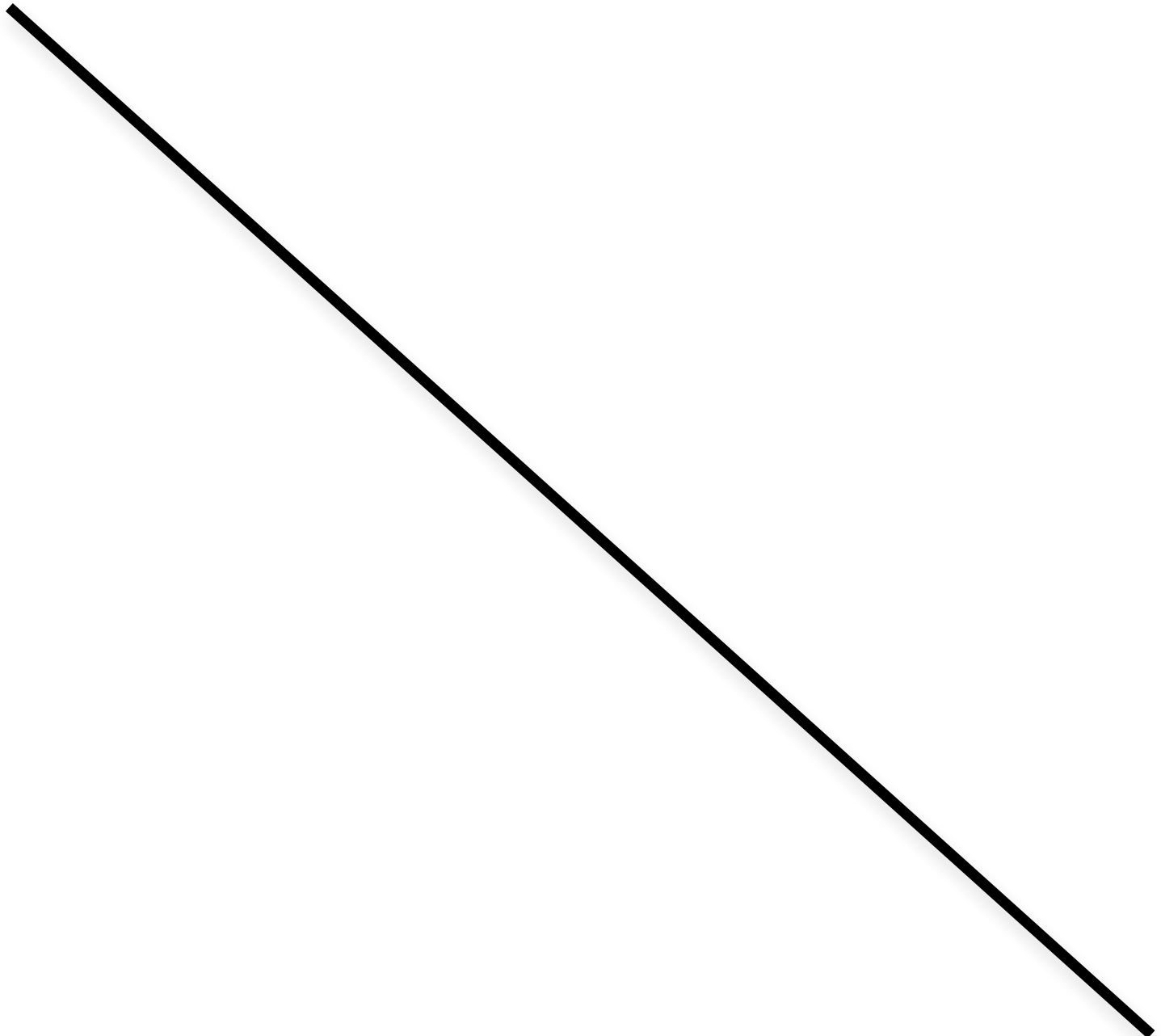


AD₁

Deflation **reduces** the size of the multiplier



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



AD₁

P_1

—

—

—

—

—

—

—

—

—

—

—

—

—

—



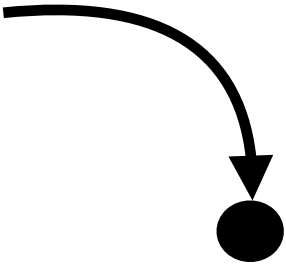
GDP₁

P_2

— — — — — — — — — —

GDP₂

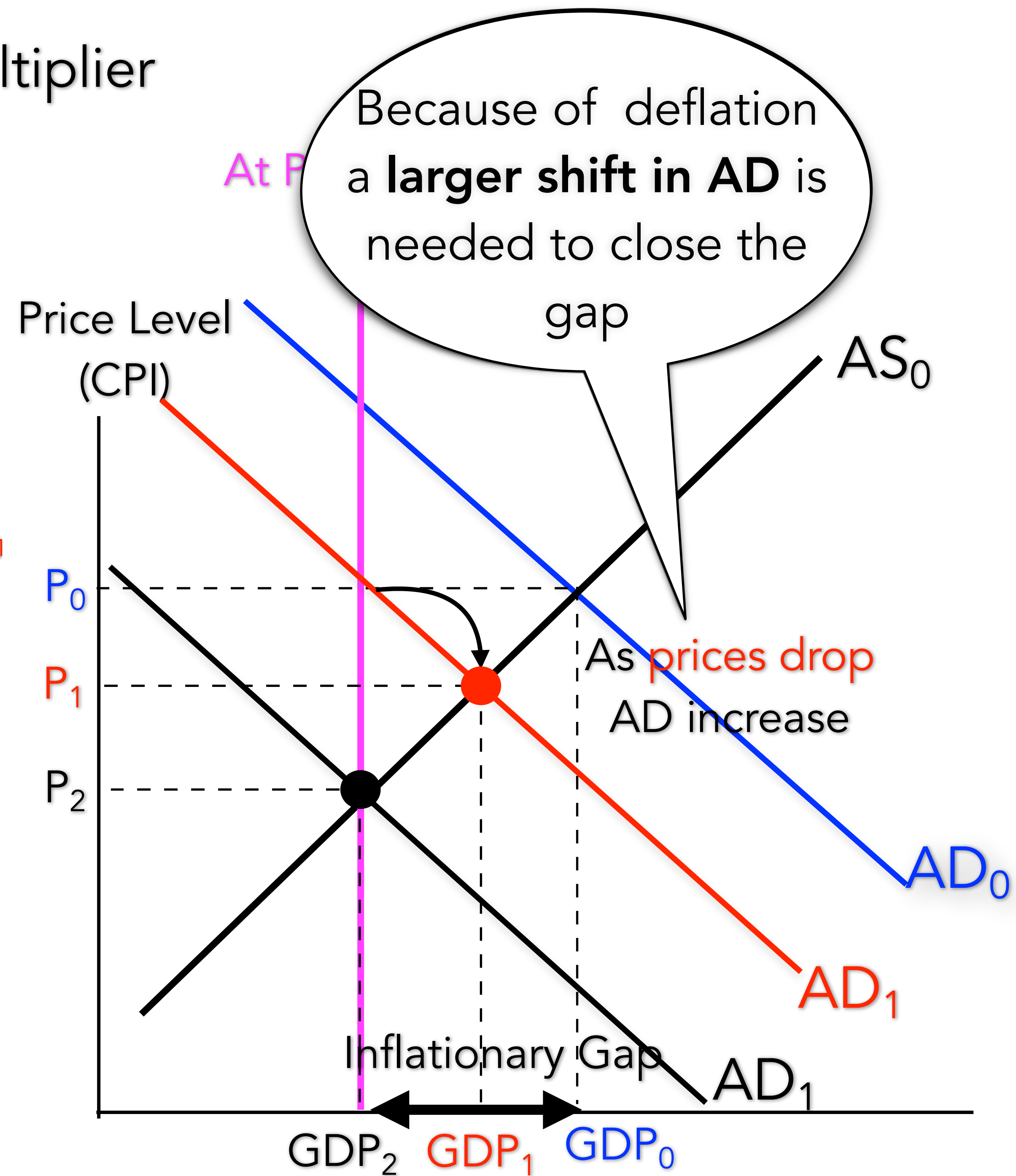
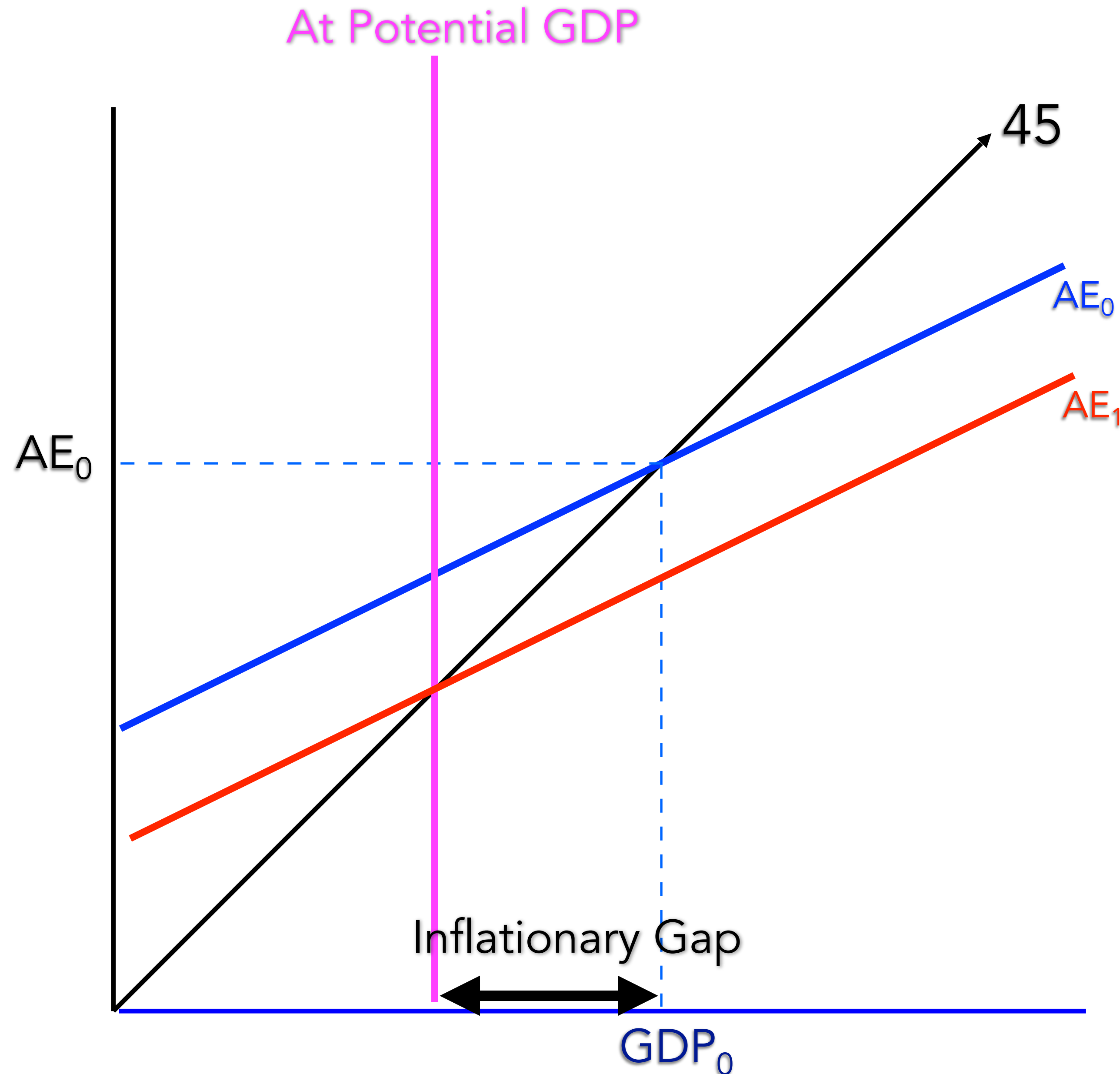




As prices drop
AD increase



Deflation **reduces** the size of the multiplier



The Effect of an Increase in Supply

