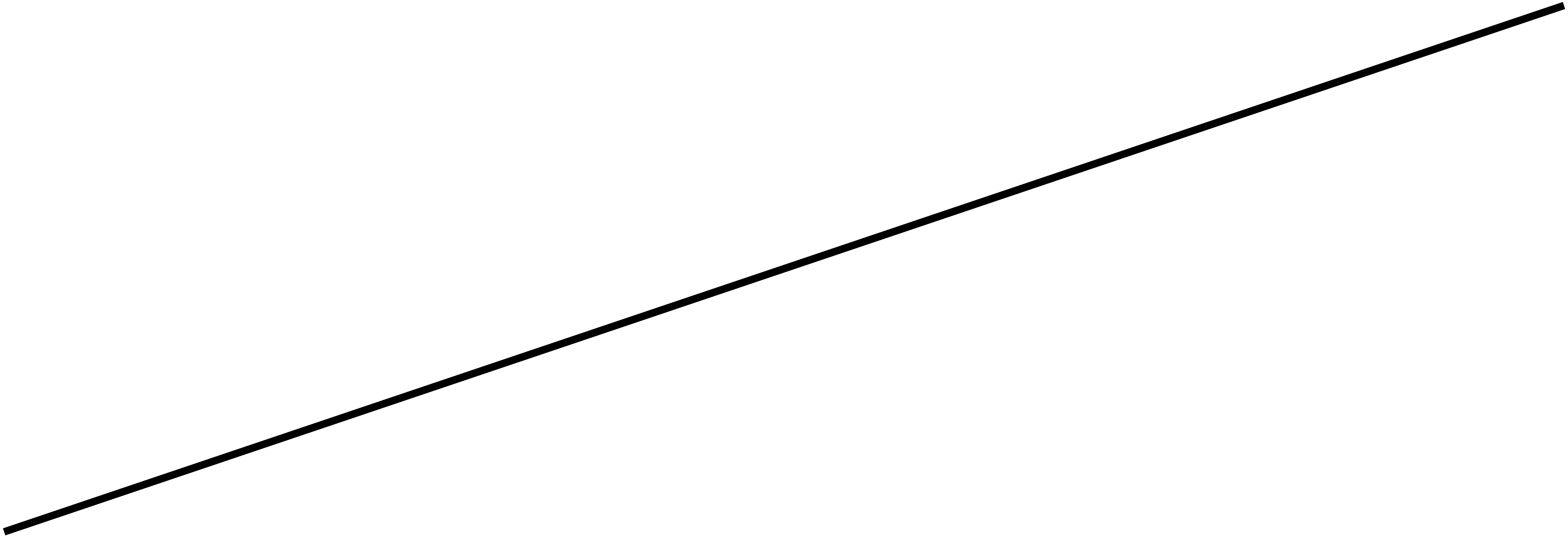
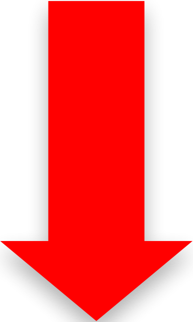
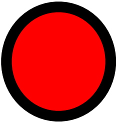
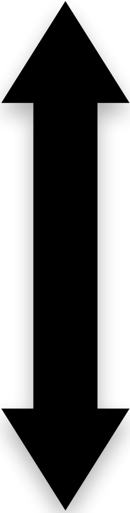






Firms decrease output



AE_0

GDP/Income

Total
Production

Total Purchases

Inventories rise

AE_1

Y_0

If AE decrease

Y_1

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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