The idea that a decline in aggregate spending may cause output to fall below potential output was one of Keynes's insights.

Too little spending leads to a recessionary output, too much creates an expansionary gap.

The Keynesian Model's Crucial Assumption: Firms Meet Demand at Preset Prices

- In the short run, firms meet the demand for their products at preset prices:
  - Firms do not respond to every change in the demand for their products by changing their prices.
  - Instead, they set a price for some period and meet the demand at that price.
    - By "meeting the demand" we mean that firms produce just enough to satisfy their customers at the prices that have been set.
  - Fluctuations in spending will have powerful effects on the nation's real GDP.

- Menu Costs: the costs of changing prices:
  - Prices should be changed if the benefit of doing so outweighs the menu costs associated with making the change.

- Planned Aggregate Expenditure (PAE): total planned spending on final goods and services - together, these four types of spending sum to aggregate spending:
  - Consumption expenditure is spending by households on final goods and services.
    - Largest component of PAE.
    - The higher the private sector's disposable income, the higher the level of consumption spending.
  - Investment is spending by domestic firms on new capital goods.
    - Also spending on new houses and apartments and increases in inventories.
  - Government purchases are purchases by federal, state, and local governments of final goods and services.
  - Next exports equal exports minus imports.
  - \[ \text{PAE} = C + I + G + NX \]