Prior to the Great Depression, Classical analysis dominated economic thought. Classical economists assumed, among other things, that wages and prices were flexible, and that markets were competitive. The Classical economists' world was one of fully utilized resources, because wages and the price level would always adjust the economy back to its potential. In the 1930s however, Europe and the United States entered a period of economic decline that could not be explained by the classical model.

John Maynard Keynes developed an explanation that has become known as the Keynesian model, one where wages and the price level did not always adjust, and especially not downwards.

Keynes and his followers argued that prices, including wages (which is the price of labor) are inflexible, or “sticky”, downward due to the existence of unions and long term contracts. He believed that when there was excess capacity and unemployment, an increase in aggregate demand would not raise the price level, and a decrease in aggregate demand would also not cause firms to lower prices.

In our AD/AS Model, given the Keynesian concept of sticky prices and wages, the short run aggregate supply curve would have to be relatively flat, so that a changing aggregate demand would not affect the price level.

The horizontal portion of the aggregate supply curve, in which there is excessive unemployment and unused capacity in the economy, depicts this notion.

Figure 11-6 depicts a flat short run aggregate supply under the Keynesian model. Notice that aggregate demand could increase from AD1 to AD2, for example, and there would be no change in the price level, as measured on the Y axis. The same is true for a fall in aggregate demand from AD1 to AD3.

The application of Keynesian analysis comes from the argument that in a depressed economy, increased aggregate spending can increase output without raising prices. A justification for this to Keynesian economists was the effect on Real GDP and the price level from 1934–1940. In such circumstances, real GDP is demand driven as the short-run aggregate supply curve is almost flat when resources are underutilized.

So who was right, the Classicals or the Keynesians?

What we have seen over times is that the price level has drifted upward in recent decades, therefore, prices are not totally sticky. Modern Keynesian analysis recognizes some—but not complete—price adjustment takes place in the short run.

The short run aggregate supply curve shows the relationship between total planned economy wide production and the price level in the short run, all other things held constant. If prices adjust in the short run, even if incompletely, then the curve is positively sloped.
In Figure 11-7 we can compare the traditional Keynesian model to the Modern Keynesian model. Notice that in the modern Keynesian model on the right, the short run aggregate supply curve is positively sloped, and as aggregate demand shifts rightward, the price level rises partially. If the aggregate supply curve were vertical, the price level would adjust fully.

In the modern Keynesian short run, when the price level rises partially, real GDP can expand beyond the level consistent with its long-run growth path.

This is because most labor contracts allow for flexibility in the total number of hours worked. The existing capital stock can also be used more intensely and efficiently. Finally, if wages don’t rise fully when prices rise, a firm is more profitable in its operations, which would induce firms to hire more workers.

All these adjustments cause real GDP to rise as the price level increases.