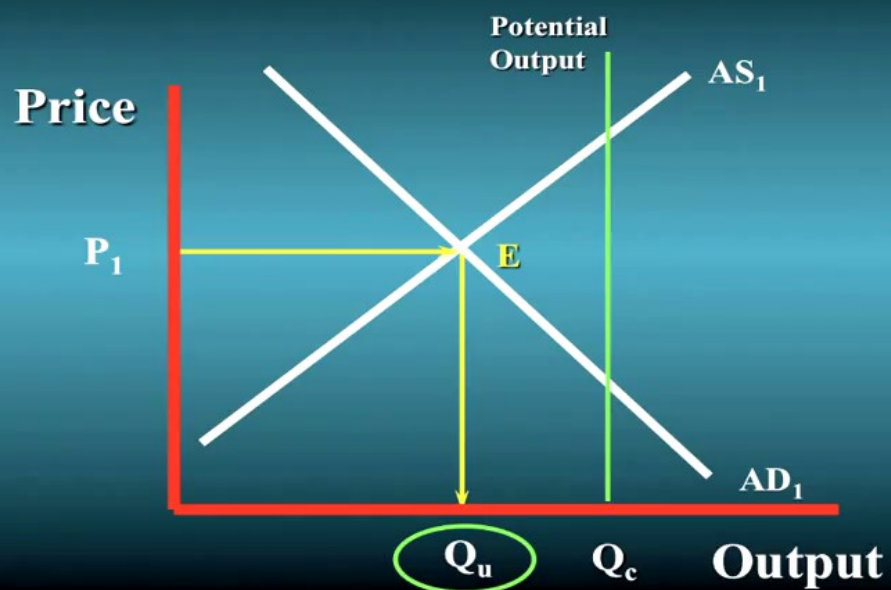


LECTURE TWO - PART FOUR

The AS-AD Framework





It shows the various amounts of real output that domestic consumers, businesses, and government along with foreign buyers collectively desire to purchase at each possible price.



The downward slope of the aggregate demand curve means that as the general price level falls, consumers and businesses will increase their demand for goods and services.

Price level

- ♦ First, there is a “real balance” or “wealth” effect.
- ♦ As price level falls, purchasing power increases, and consumers demand more goods and services.
- ♦ This is because the real value of money is measured by how many goods and services each dollar will buy.
- ♦ A lower price level increases the real value or purchasing power of accumulated financial assets such as savings accounts and bonds that have fixed money values.

AD

Real domestic output, GDP

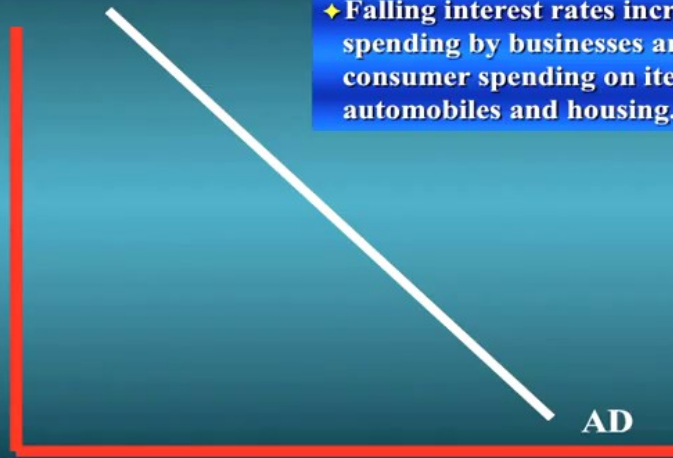
Price level

- ♦ For example, a household might not buy a new car or sailboat if the purchasing power of its assets is only \$30,000.
- ♦ If there is “deflation” and the price level falls, the household’s real purchasing power may increase to, say, \$50,000 so the new purchase is more likely to be made.

AD

Real domestic output, GDP

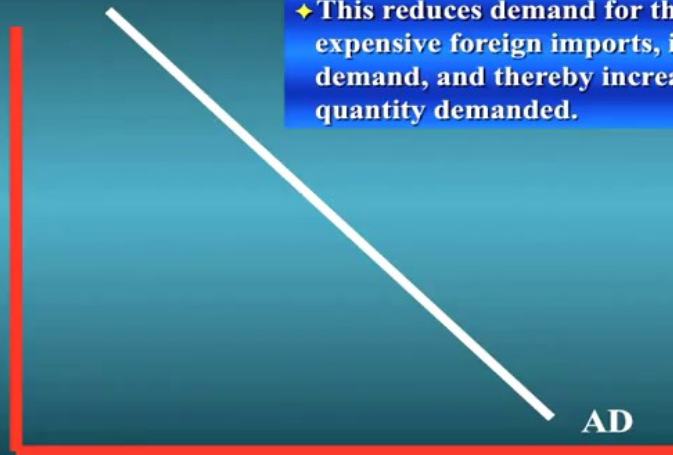
Price level



Real domestic output, GDP

- ♦ A second reason why the aggregate demand curve slopes downward is an “interest rate effect.”
- ♦ As the price level falls, so do interest rates.
- ♦ Falling interest rates increase investment spending by businesses and certain kinds of consumer spending on items such as automobiles and housing.

Price level



Real domestic output, GDP

- ♦ Third, there is a “foreign purchases,” “foreign-trade,” or “net export effect.”
- ♦ As the domestic price level falls, the relative price of foreign goods increases.
- ♦ This reduces demand for the now more expensive foreign imports, increases export demand, and thereby increases aggregate quantity demanded.