

Assignment 5

Due on April, 18th at the BE office before 3 pm.

Question 1

In class, we discussed the case for credit market equilibrium when consumer is a net-saving agent whereas government is a net-borrowing agent. This exercise will go along the opposite direction where their roles will be reversed. We suppose that government sets its course of budget policy with budget surplus, i.e. $G < T$. Consider the following problem.

1.1) Use the notation introduced in class, construct the graphical illustration shows that consumer is initially a net-saving agent at the observed interest rate “ r ”. Correctly locate all the important points, and explain what they mean by.

1.2) Following (1.1) and the budget surplus policy adopted by the government, argue for the reason that the prevailing interest rate is not a competitive equilibrium.

1.3) Let's assume that r^* is the equilibrium real interest rate. Do you think the equilibrium interest rate should be higher or lower than the currently observed level denoted by “ r ”? What assumptions about substitution and income effect do we require so that your argument can be valid?

1.4) Given the level of r^* as argued in (1.3), graphically construct the competitive equilibrium allocation using the consumption-saving figure. Locate all the important points, and explain what they are (including why they are so). Make sure that your illustrations meet all the conditions required for the credit market equilibrium.

1.5) Based on the analytical reasoning discussed in (1.1) - (1.4), do you think the equilibrium interest rate should be higher or lower if consumer experiences a permanent increase in the level of income?