

EE312 Macroeconomics, 2/2015 (Sec. 046402)
Problem Sets 4 : Chapter 5

Please submit at the BE office, 5th floor department of Economics building.

Deadline of submission : Thursday 30, March 2016, before 15.00 hrs.

Late submission will not be accepted.

*** Exam will consist of essay-type questions only.**

Chapter 5. Two-period Model. Consumption and Saving Decision.

PART 1. True or False. Short Answer. If the statement is False, comment.

1. (T/F) Consumption smoothing implies that consumers consume the same amount each period.
(Explain)
2.(T/F) Consumption smoothing has empirical support because real GDP is less variable than aggregate consumption
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3.(T/F) Eliminating consumer durables from the measure of real aggregate consumption would lead to greater variability of consumption with respect to aggregate income.
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4.(T/F) An increase in the real interest rate might cause a lender to increase current consumption if the substitution effect outweighs the income effect.
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6. A decrease in the real interest rate might cause a borrower to decrease current consumption if the substitution effect outweighs the income effect.
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7.(T/F) A temporary increase in income leads to an increase in saving while a permanent increase in income need not result in more saving
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8.(T/F) Under Ricardian Equivalence, a change in current taxes (say a decrease of \$10 billion), exactly offset by an equal and opposite change in future taxes (an increase of \$10 billion), has no effect on the real interest rate or on the consumption of individual consumers in equilibrium.
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9.(T/F) Milton Friedman argued that the marginal propensity to consume out of temporary income is greater than the marginal propensity to consume out of permanent income.
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Part 2. Short Answer.

1. Assuming $r = 0.25$, $t = 10$, $t' = 20$, $y = 100$ and $y' = 100$, write the consumer's lifetime budget constraint and derive the consumer's lifetime wealth.

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2. Show graphically the effect of a decrease in the real interest rate on current-period consumption for a lender whose income effect outweighs the substitution effect.

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