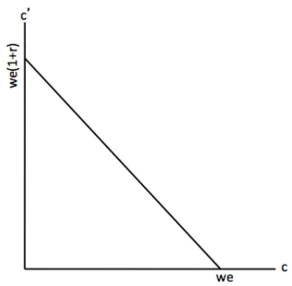
Chapter 8. Two Period Model Consumption-Savings Decision and The Credit Market

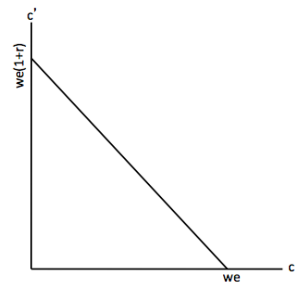
1. Intertemporal Consumption : borrower VS lender

2. An increase in current income



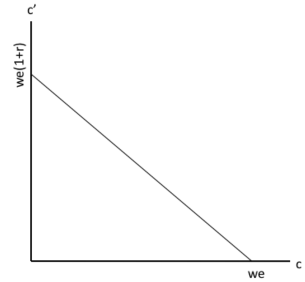
- current income ↑ from y_1 to y_2
- current consumption ....
- Δc.......Δy
- future consumption ....
- saving ....

3. An increase in future income



- future income↑ from y_1' to y_2'
- future consumption ....
- $\Delta c'$.......$\Delta y'$
- current consumption ....
- saving ....

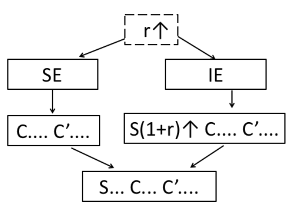
4. Temporary and permanent ↑ in y

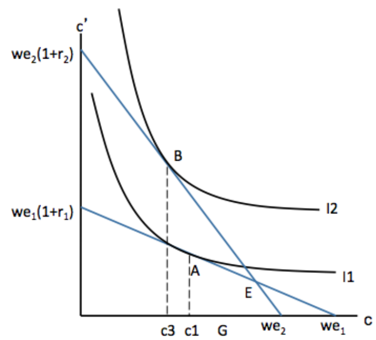


- **HJ** = effect of temporary rise in y.
- **HK** = effect of permanent rise in y.
- **A temporary increase in y** : HL, the budget line shifts from AB to ED.
- **A permanent increase in y** : $y_2 - y_1$= HL $= y_2' - y_1'$= LM. : the budget line shifts from AB to GF.

5. An increase in the real interest rate

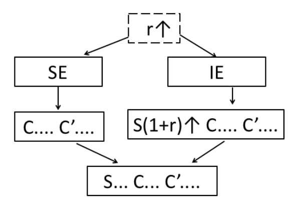
The consumer is a lender

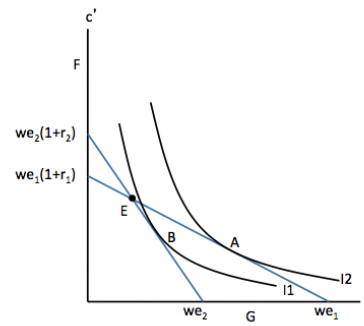




Lender: stronger SE

The consumer is a borrower





Borrowers:

6. Government's budget constraint: ....

7. Equilibrium (1) The credit market clears. (2) The income-expenditure identity.

8. The Ricardian Equivalence

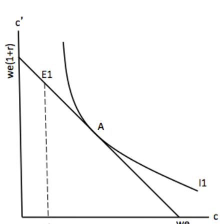
(1)

(2)

- Δt is matched by $-\Delta t(1+r)$, (1) holds
- (2) remains unchanged

- $t\downarrow$, $S^p\uparrow$ and $S^g\downarrow$ by the same amount.
- The consumption bundle ....
- $\Delta S^p = \Delta B = \Delta T$ so the credit market equilibrium remains.

A current tax cut equals a future tax increase



Unchanged credit market