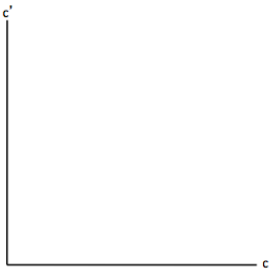
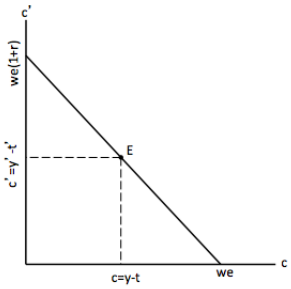
EE312 Macroeconomics, 1/2014 (Sec. 046402)
Chapter 5. Two Period Model Consumption-Savings Decision and The Credit Market

1 Intertemporal Consumption

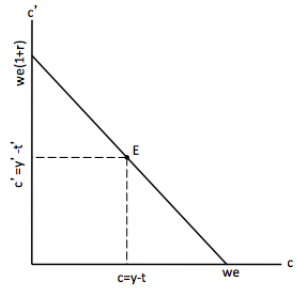
Budget line:



Lender

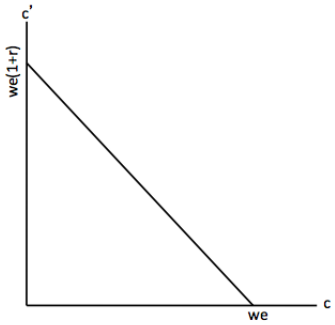


Borrower



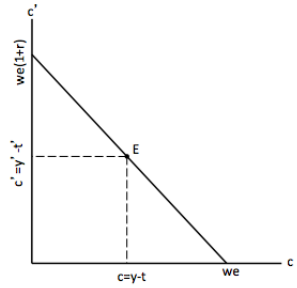
2 An increase in current income

An increase in current income



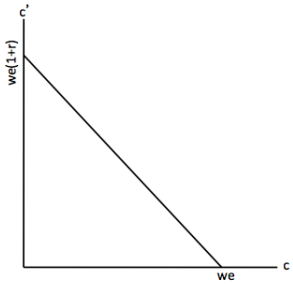
- current income increases from y_1 to y_2 ($\Delta y =$ .....)
- current consumption .....
- Δc.....Δy
- future consumption .....
- saving .....

Lenders



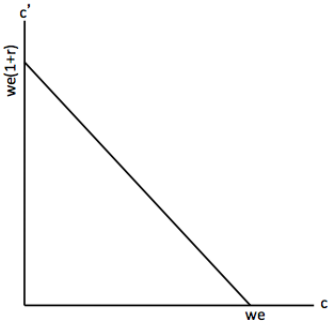
3 An increase in future income

- future income increases from y_1' to y_2' ($\Delta y' =$ ..... ; mark/show the value on the graph)
- future consumption .....
- $\Delta c'$.....$\Delta y'$
- current consumption .....
- saving .....

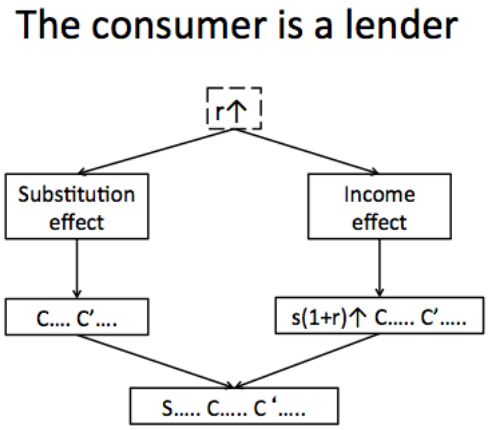


4 Temporary and permanent increases in income

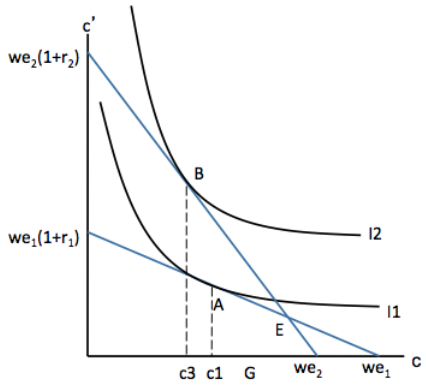
- **HJ** = effect of temporary rise in y.
- **HK** = effect of permanent rise in y.
- **A temporary increase in y** = HL: the budget line shifts from AB to ED.
- **A permanent increase in y** = ($y_2 - y_1 = y_2' - y_1'$, $y_2 - y_1$= HL = $y_2' - y_1'$= LM.) : the budget line shifts from AB to GF.

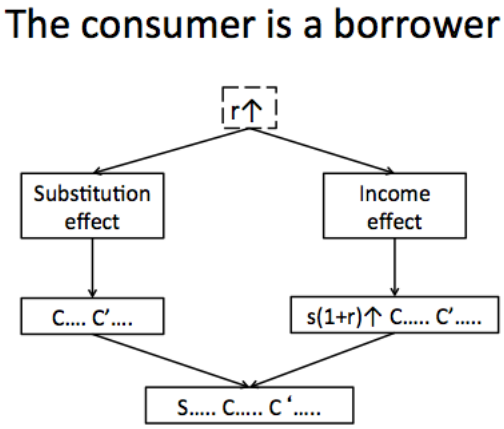


5 An increase in the real interest rate

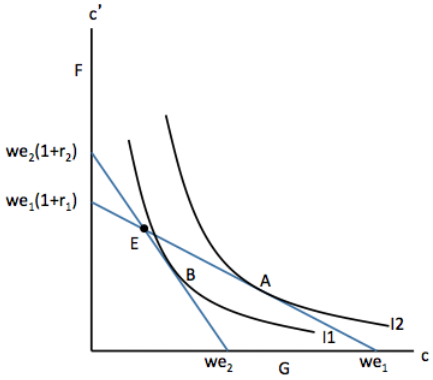


Lender: stronger substitution effect





Borrowers:



6 The government sector

- Government's **budget constraint**: .....
- Equilibrium (1) The credit market clears. (2) The income-expenditure identity.

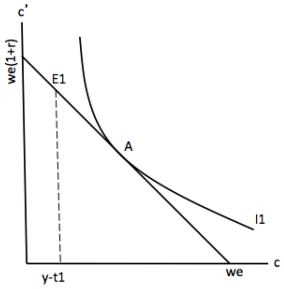
The Ricardian Equivalence

(1)

(2)

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

A current tax cut equals a future tax increase



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

Unchanged credit market