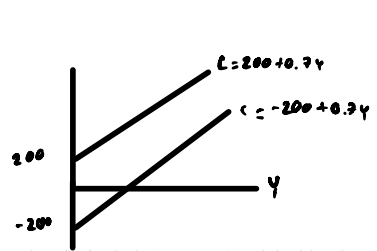


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1. The Keynesian consumption function assumes that  $0 < MPC < 1$ ; what is the basis for such assumption?

When the income increases, we will consume more but not as much as the increase in their income

2. Assume a CLOSED economy with NO government. Let the autonomous consumption be 200 and MPS be 0.3. Draw and write equations for both saving and consumption functions.



$MPC = 0.3$   
 $MPS = 0.7$

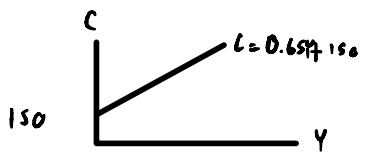
consumption func:  $C = a + by$   
 $C = 200 + 0.7Y$

Saving function:  $Y = C + S$   
 $S = Y - C$   
 $S = -200 + 0.3Y$

3. Let the saving function be  $S = -150 + 0.35Y$ . Find and draw the consumption function.

$S = -150 + 0.35Y$

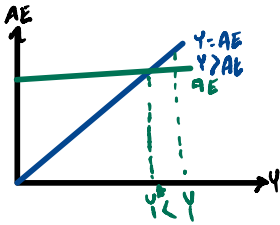
$Y = C + S$   
 $C = Y - S$   
 $C = 0.65Y + 150$



4. How do the followings affect the AE graph (i.e. explain how the graph changes) and the equilibrium output?

- All firm managers decide to buy fewer machines. AE shift down (decrease)
- The government decides to build more roads. AE shift up (increase)
- The citizens decide to save more at all income levels. AE will shift down (decrease)
- The citizens decide to save larger proportion of income. AE will be flatter
- The government decides to raise tax. AE will shift down decrease

5. In the Keynesian Cross Model, suppose that aggregate output is greater than aggregate expenditure. Explain the adjustment process towards the equilibrium.



Inventory will < cut back the production

6. Let  $C = 60 + 0.6Y$  and  $I = 20$ . Find the equilibrium output with the saving/investment approach.

saving function

$$S = I$$

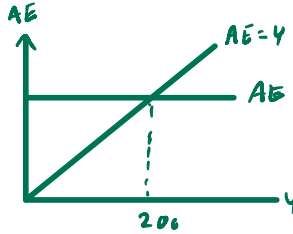
$$Y - C = S$$

$$Y - 60 - 0.6Y = 20$$

$$0.4Y = 80$$

$$Y = 200$$

$$\therefore \text{equilibrium } Y = 200$$



7. Let  $S = -60 + 0.4Y$  and  $I = 20$ . Find the equilibrium output with the standard approach.  
Now, suppose  $I$  increases by 20. Find the new equilibrium and the investment multiplier.

$$C = Y - S$$

$$Y = AE = C + I$$

$$Y = Y + 60 - 0.4Y$$

$$Y = 0.6Y + 60$$

$$0.4Y = 60$$

$$Y = 200$$

$$\text{Now } I = 40$$

$$Y = Y + 60 - 0.4Y + 40$$

$$Y = 0.6Y + 200$$

$$Y = \frac{100}{0.4}$$

$$Y = 250$$

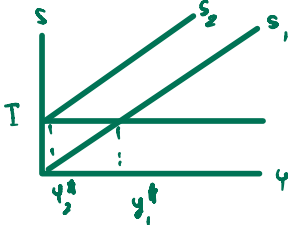
8. With the multiplier effect, an injection of money (for example, investment) can lead to a greater proportional increase in output. Explain how this can happen.

The concept is that the outcome of one is the income of another. So the increase of investment will affect more outcome.

9. How is the investment multiplier related to MPC? Explain the intuition behind such relationship. (Hint: Question 9)

The MPC is higher so multiplier would be higher too.

10. What is the Paradox of Thrift? Explain it with diagram.



When people save more, the saving become less than before.