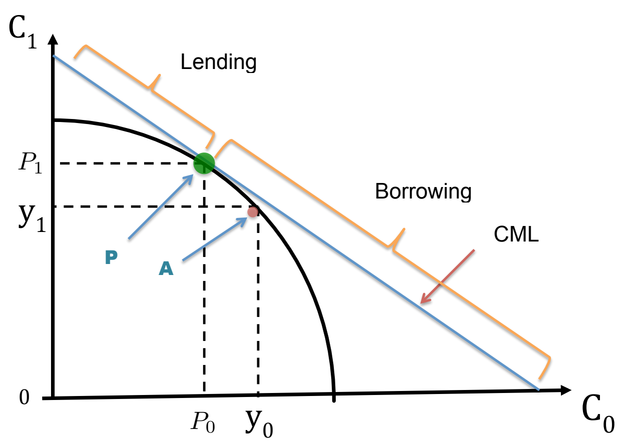
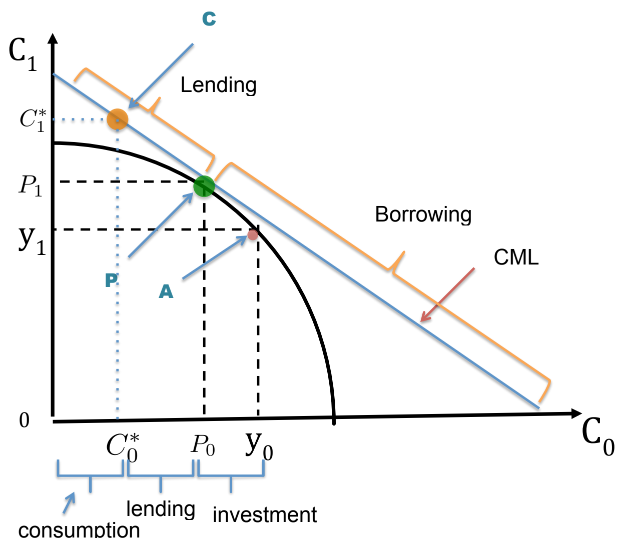
Topic 2: Capital, Consumption and Investment with the Financial Market

September 23, 2011



- This consumer endowment is (y_0, y_1). He or she will choose to produce at point P where CML is tangent to the PPC.
- The distance between y_0 and P_0 is investment. After he/she invests, he/she would have P_0 left for his/her current consumption.
- Therefore, if he/she wants his/her current consumption (C_0^*) to be greater than P_0, he/she has to borrow from the financial market at the market interest rate r (along CML below point P).
- If he/she wants his/her current consumption (C_0^*) to be lower than P_0, he/she can to lend some amount to the financial market at the market interest rate r (along CML above point P).

Example:



- The picture above illustrates the case in which a consumer chooses to lend.
- The consumer has initial current income of y_0. The distance between y_0 and P_0 is investment. After he/she invests, he/she would have P_0 left.
- The consumer wants to consumes C_0^* at the current which is less than what he/she has, which is equal to P_0.
- The distance between C_0^* and P_0 is his/her lending.