EC2102 Macroeconomic Analysis I
Tutorial 5, Week 8, March 8-12, 2010)

Time goes on forever. An economy consists of an infinitely-lived individual who values consumption and leisure, and has h units of time each period; an infinitely lived representative firm which is owned by the consumer; and a government. Let us assume that the government plans to spend G_t at time period t where $G_t \geq 0$ for all t, and its tax revenues of T_t levied on the representative consumer is such that its lifetime budget constraint holds. Production at the representative firm is $Y_t = z_t F(K_t, N_t)$.

Suppose also that the economy is initially in an equilibrium. The labour and goods market equilibria in time period 1 are illustrated in figure 1.

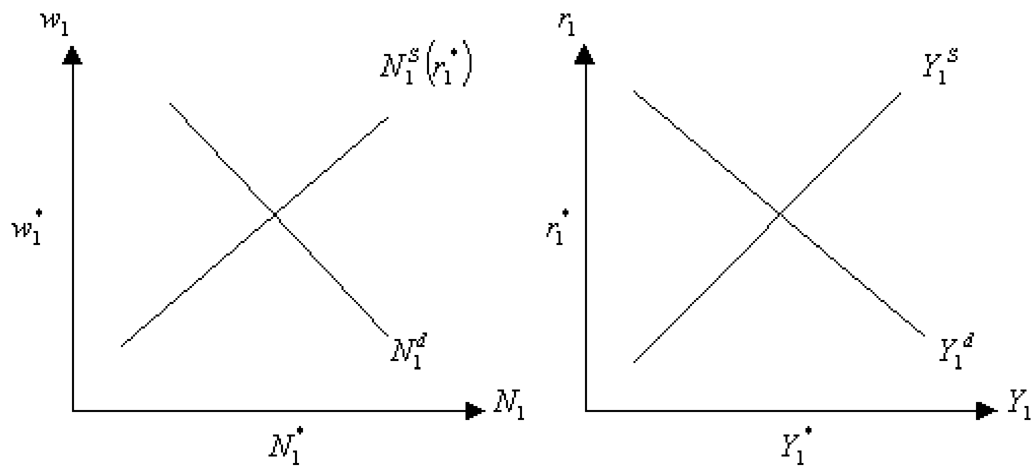

Figure 1

Consider two scenarios listed below, and explain clearly how each affects equilibria in the labour and goods market in time period 1 as illustrated in figure 1, taking care to explain clearly the impact on the decisions made in time period 1 by the representative consumer and the representative firm.

Scenario 1

At the beginning of time period 1, the government announces that it will cut the amount of government expenditures at time period 1, and only time period 1, by exactly Φ, where $\Phi < G$.

Scenario 2

At the beginning of time period 1 there is a decrease in z_1 from z_1 to $\widehat{z}_1$.