Ec 1936, Keynes

Problem Set 4.
Due Monday, October 25, 11.59 pm.

Qeustion 1. Alternative Theories of Consumption and Saving. (This question has six parts.)

The permanent-income and life-cycle hypotheses (PIH and LCH) arose from the inconsistency of estimates of the relationship between income and consumption based on *cross sections* of family income and spending and estimates based on *time series* of aggregate income and consumption. Based on a cross section of family incomes, the marginal propensity to consume (MPC) appeared to be relatively low, and the intercept (reflecting the level of consumption at an income equal to zero) fairly high (see Figure 1 below). Based on aggregate time series, the MPC appeared to be quite high and the intercept zero or thereabouts (see Figure 2).

Family Consumption Function

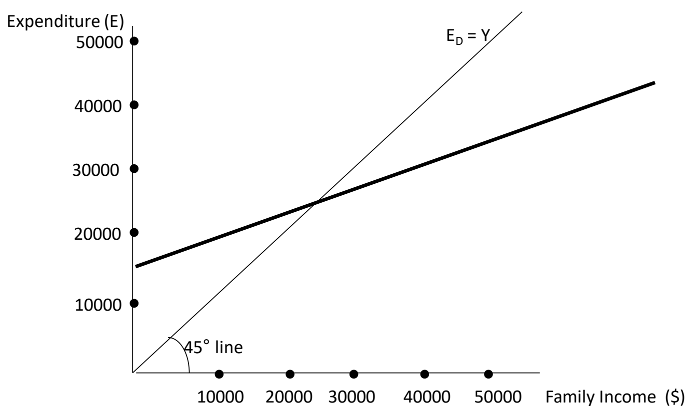

Figure 1

Aggregate Consumption Function

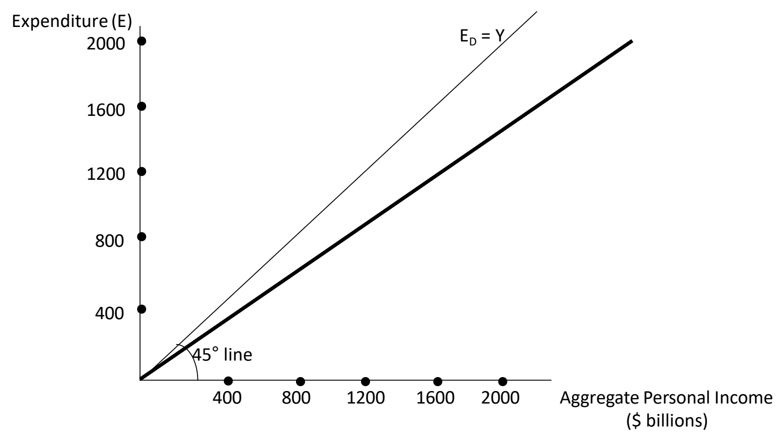

Figure 2

1. How does each hypothesis explain the inconsistency?

2. In what ways are the two hypotheses similar? In what ways are they different?

3. How do the basic assumptions of these two hypotheses differ from the basic assumptions of the consumption function of *The General Theory*?

4. What are the implications of the PIH and the LCH for the investment multiplier?

5. Why would some groups of the population be less likely than others to follow the dictates of the PIH/LCH in responding to temporary tax cuts or temporary increases in transfer payments like social security?

6. How do the basic assumptions of the two hypotheses differ from the basic assumptions of the Cambridge saving theory?

Question 2. Capital Widening and Capital Deepening. (This question has six parts.)

1. What is the conceptual difference between saving and investment?

2. Why are saving and investment nevertheless equal in the national income and product accounts (up to statistical discrepancy that depends on empirical measurement)?

3. Define capital-widening and capital-deepening investment.

4. Why does capital-widening investment respond positively to the real price whereas capital-deepening investment responds negatively to the real price?

5. How does the business cycle affect the relative importance of the two kinds of investment?

6. What implications, if any, does your answer to Part 3 have for wage policy in a deep recession like the period that followed the financial crisis of 2008?