

# Homework 6

**Tate Mason**

Collaboration to varying degrees with Timothy Duhon,  
Josephine Hughes, Abdul Khan, Kasra Lak, Rachel Lobo,  
Mingzhou Wang, Wenyi Wang

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An ECON - 8040 Homework Assignment

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## Question 1

### Problem

Consider the example of our endowment economy with two types of households. Assume utility function is

$$u(c) = \frac{c^{1-\sigma} - 1}{1-\sigma} \text{ for } \sigma > 0$$

Also assume endowments growth at constant rate, i.e.,

$$e_t^1 = \begin{cases} 2\gamma^t & \text{if } t \text{ is even} \\ 0 & \text{if } t \text{ is odd} \end{cases}$$
$$e_t^2 = \begin{cases} 0 & \text{if } t \text{ is even} \\ 2\gamma^t & \text{if } t \text{ is odd} \end{cases}$$

Let  $0 < \beta < 1$  be discount rate and assume  $\beta\gamma^{1-\sigma} < 1$ . (Note: for  $\sigma = 1$ ,  $u(c) = \log(c)$ . Therefore the example we studied in class was a special case of this problem with  $\gamma = 1$  and  $\sigma = 1$ )

### Parts

(a)

Define (Arrow-Debreu) competitive equilibrium.

(b)

Derive household's Euler equation.

(c)

Write down a social planner problem for some Pareto weights and solve for Pareto efficient allocations (treat Pareto weights as parameters). hint: it is easier to solve everything in terms of the ratio of weights  $\alpha \equiv \frac{\alpha_2}{\alpha_1}$ .

(d)

Use Negishi Method to solve for competitive equilibrium allocations and prices.

(e)

Find Pareto weights that generate the following allocation  $(c_t^1, c_t^2) = (\gamma^t, \gamma^t)$ . Find transfers needed to implement this allocation in a competitive equilibrium.

(f)

How does growth rate of consumption depend on  $\gamma$  and  $\sigma$ ? How do equilibrium prices depend on  $\gamma$  and  $\sigma$ ?

(g)

Define a sequential market competitive equilibrium. Find interest rate in this equilibrium. How do equilibrium interest rate depend on  $\gamma$  and  $\sigma$ ?

## Solutions

(a)

$$\max_{\{c_t^i\}_{t=0}^{\infty}} \sum_{t=0}^{\infty} \beta^t \left( \frac{c_t^{i1-\sigma} - 1}{1-\sigma} \right)$$

s.t.

$$\begin{aligned} \sum_{t=0}^{\infty} \hat{p}_t c_t^i &\leq \sum_{t=0}^{\infty} \hat{p}_t e_t^i \\ \hat{c}_t^i &\geq 0 \\ 0 &< \beta < 1 \end{aligned}$$

Markets Clear:

$$\hat{c}_t^1 + \hat{c}_t^2 = \hat{e}_t^1 + \hat{e}_t^2 \quad \forall t$$

(b)

$$\begin{aligned} c_t^i &: \frac{\beta^t}{c_t^{i\sigma}} - \lambda p_t \\ c_{t+1}^i &: \frac{\beta^{t+1}}{c_{t+1}^{i\sigma}} - \lambda p_{t+1} \\ \beta \frac{c_{t+1}^{i\sigma}}{c_t^{i\sigma}} &= \frac{p_t}{p_{t+1}} \\ c_{t+1}^{i\sigma} p_{t+1} &= \beta c_t^{i\sigma} p_t \end{aligned}$$

(c)

$$\max_{\{c_t^1, c_t^2\}_{t=0}^{\infty}} \sum_{t=0}^{\infty} \beta^t \left[ \alpha_1 \frac{c_t^{11-\sigma} - 1}{1-\sigma} + \alpha_2 \frac{c_t^{21-\sigma} - 1}{1-\sigma} \right]$$

s.t.

$$c_t^1 + c_t^2 = e_t^1 + e_t^2 = 2\gamma^t; \lambda$$

Lagrangian:

$$\begin{aligned}\mathcal{L} &= \sum_{t=0}^{\infty} \alpha \sum_{t=0}^{\infty} \beta^t \frac{c_t^{1-\sigma} - 1}{1-\sigma} + \frac{\mu}{2} \left[ \sum_{t=0}^{\infty} e_t^i - \sum_{t=0}^{\infty} c_t^i \right] \\ \mathcal{L}_c &= \alpha \beta c^{-\sigma} - \frac{\mu}{2} = 0 \\ c_t^1 &: \alpha_1 \beta c_t^{1-\sigma} - \frac{\mu}{2} \\ c_t^2 &: \alpha_2 \beta c_t^{2-\sigma} - \frac{\mu}{2}\end{aligned}$$

Divide the two FOC's

$$\begin{aligned}\frac{\alpha_1 \beta c_t^{1-\sigma} - \frac{\mu}{2}}{\alpha_2 \beta c_t^{2-\sigma} - \frac{\mu}{2}} \\ 1 &= \frac{\alpha_1}{\alpha_2} \left( \frac{c_t^1}{c_t^2} \right)^{-\sigma} \\ \left( \frac{\alpha_2}{\alpha_1} \right)^{\sigma} &= \frac{c_t^1}{c_t^2} \\ \alpha &\equiv \frac{\alpha_2}{\alpha_1} \Rightarrow c_t^1 = c_t^2 \alpha^{\sigma} \\ \alpha^{\sigma} c_t^2 + c_t^2 &= 2\gamma \\ c_t^2 &= \frac{2\gamma}{1 + \alpha^{\sigma}} \\ c_t^1 &= \frac{2\gamma}{1 + \alpha^{-\sigma}}\end{aligned}$$

(d)

Solving for  $\mu$

$$\begin{aligned}\mu_1 &= 2(\alpha \beta [\frac{2\gamma}{\alpha^{-\sigma} - 1}]^{-\sigma}) \\ \mu_2 &= 2(\alpha \beta [\frac{2\gamma}{\alpha^{\sigma} - 1}]^{-\sigma})\end{aligned}$$

## Question 2

### Problem

Consider the economy in question 1. Assume  $\sigma = 1$  (so log utility) and  $\gamma = 1$ . Assume the following endowments

$$\begin{aligned}e_t^1 &= (2, 0, 2, 0, 2, \dots) \\ e_t^2 &= (2, 2, 2, 2, 2, \dots)\end{aligned}$$

## Parts

(a)

Find equilibrium allocations and prices. Are prices different than the one we derived during lecture? Why?

(b)

Define a sequential market competitive equilibrium. Find interest rate in this equilibrium.

## Solutions

(a)

$$\max_{c_{t=0}^i} \sum_{t=0}^{\infty} \beta^t \ln(c_t^i)$$

s.t.

$$\begin{aligned} \sum_{t=0}^{\infty} \hat{p}_t c_t^i &\leq \sum_{t=0}^{\infty} \hat{p}_t e_t^i \\ \hat{c}_t^i &\geq 0 \\ 0 &< \beta < 1 \end{aligned}$$

Markets Clear:

$$e_t^1 + e_t^2 = c_t^1 + c_t^2 = \begin{cases} 4, & \text{if } t \text{ is odd} \\ 2, & \text{if } t \text{ is even} \end{cases}$$

## Question 3

### Problem

Consider the economy in question 2. Assume the following endowments

$$e_t^1 = (2, 1, 2, 1, 2, \dots)$$

$$e_t^2 = (2, 1, 2, 1, 2, \dots)$$

Find equilibrium allocations and prices. Does any trade happen in this equilibrium? Why?

### Solution

Trade is not beneficial since prices are equal for both agents. Thus, they are able to be self-sufficient, not requiring the other to consumption smooth.

## Question 4

### Problem

Consider an economy with two types of household with the following preferences

$$\sum_{t=0}^{\infty} \beta_i^t \log(c_t^i) \text{ for } i = 1, 2$$

The households are different in their discount factor  $0 < \beta_1 < \beta_2 < 1$ . Both households have endowment of  $e_t = 1$  every period.

### Parts

(a)

Define (Arrow-Debreu) competitive equilibrium. And derive household's Euler equation.

(b)

Write down a social planner problem for some Pareto weights and solve for Pareto efficient allocations (treat Pareto weights as parameters).

(c)

Use Negishi Method to solve for competitive equilibrium allocations and prices. (hint: you can find weights that correspond to equilibrium by examining feasibility at  $t = 0$  (or  $t = \infty$ ))

(d)

How does  $\frac{c_t^1}{c_t^2}$  move over time? What is its limit?

(e)

Explain what is happening here.

### Solutions

(a)

## Question 5 (Bonus)

### Problem

Consider a two period endowment economy with a single consumption good,  $c$ . The economy is comprised of 2 types of households with identical preferences over consumption in periods  $t = 0, 1$

$$u(c_0^k) + u(c_1^k), k = 1, 2$$

Fraction  $\eta$  of households are of type 1 and have endowments  $(e_0^1, e_1^2) = (1, 0)$ . The rest of the households are of type 2 and have endowments  $(e_1^2, e_1^2) = (0, 1)$ . There is no production technology and consumption good is non-storable.

## Parts

(a)

Let  $a_k$  be one period arrow security in this economy ( $k = 1, 2$ ) with associated interest rate  $i$ . Households have no initial assets. There are no other assets in the economy. Define sequential market competitive equilibrium.

(b)

Assume  $u(c) = \log c$ . Find interest rate  $i$  as function of  $\eta$ . What happens to interest rate as  $\eta$  increases?

(c)

Discuss your answer to part (b). What is the intuition?