

Assume

$$U(c_1, c_2) = \log(c_1) + \beta \log(c_2), \quad \beta = 1, \quad R = 0,$$

Start from the baseline income profile  $(y_1, y_2) = (10, 10)$ .

1. Compute baseline current consumption  $c_1$ .

2. Transitory shock:  $(y_1, y_2) = (11, 10)$ .

Find the new  $c_1$ . How much of the extra unit of income today is consumed today, and how much is saved?

3. Persistent shock:  $(y_1, y_2) = (11, 11)$ .

Find the new  $c_1$ . How much of the extra unit of income today is consumed today, and how much is saved?

4. Compare the two answers and explain the difference.