

ECON 337901

FINANCIAL ECONOMICS

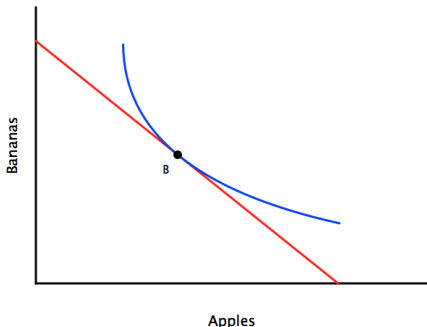
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Consumer Optimization: Graphical Analysis



At B, the optimal choice, the indifference curve is tangent to the budget constraint.

Consumer Optimization: Graphical Analysis

The tangency of the budget constraint and indifference curve can also be expressed mathematically as

$$\frac{p_a}{p_b} = \frac{u'(c_a)}{\beta u'(c_b)}.$$

The marginal rate of substitution equals the relative prices.

Consumer Optimization: Graphical Analysis

Returning to the more general expression

$$c'_b(c_a) = -\frac{u'(c_a)}{\beta u'[c_b(c_a)]},$$

we can see that $c'_b(c_a) < 0$, so that the indifference curve is downward-sloping, so long as the utility function u is strictly increasing, that is, if more is preferred to less.

Consumer Optimization: Graphical Analysis

$$c'_b(c_a) = -\frac{u'(c_a)}{\beta u'[c_b(c_a)]}$$

Differentiating again yields

$$c''_b(c_a) = -\frac{\beta u'[c_b(c_a)]u''(c_a) - u'(c_a)\beta u''[c_b(c_a)]c'_b(c_a)}{\{\beta u'[c_b(c_a)]\}^2},$$

which is positive if u is strictly increasing (more is preferred to less) and concave (diminishing marginal utility). In this case, the indifference curve will be convex. Again, we see how concave functions have mathematical properties and economic implications that we like.

Consumer Optimization: Algebraic Analysis

Graphical analysis works fine with two goods.

But what about three goods? That depends on how good an artist you are.

And what about four or more goods? Hard to even imagine what that graph would look like.

But once again, calculus makes it easier!

Consumer Optimization: Algebraic Analysis

Consider a consumer who likes three goods:

Y = income

c_i = consumption of goods $i = 0, 1, 2$

p_i = price of goods $i = 0, 1, 2$

Suppose the consumer's utility function is

$$u(c_0) + \alpha u(c_1) + \beta u(c_2),$$

where α and β are weights on goods 1 and 2 relative to good 0.

Consumer Optimization: Algebraic Analysis

The consumer chooses c_0 , c_1 , and c_2 to maximize the utility function

$$u(c_0) + \alpha u(c_1) + \beta u(c_2),$$

subject to the budget constraint

$$Y \geq p_0 c_0 + p_1 c_1 + p_2 c_2.$$

The Lagrangian for this problem is

$$L = u(c_0) + \alpha u(c_1) + \beta u(c_2) + \lambda(Y - p_0 c_0 - p_1 c_1 - p_2 c_2).$$

Consumer Optimization: Algebraic Analysis

$$L = u(c_0) + \alpha u(c_1) + \beta u(c_2) + \lambda(Y - p_0 c_0 - p_1 c_1 - p_2 c_2).$$

First-order conditions:

$$u'(c_0^*) - \lambda^* p_0 = 0$$

$$\alpha u'(c_1^*) - \lambda^* p_1 = 0$$

$$\beta u'(c_2^*) - \lambda^* p_2 = 0$$

Consumer Optimization: Algebraic Analysis

The first-order conditions

$$u'(c_0^*) - \lambda^* p_0 = 0$$

$$\alpha u'(c_1^*) - \lambda^* p_1 = 0$$

$$\beta u'(c_2^*) - \lambda^* p_2 = 0$$

imply

$$\frac{u'(c_0^*)}{\alpha u'(c_1^*)} = \frac{p_0}{p_1} \text{ and } \frac{u'(c_0^*)}{\beta u'(c_2^*)} = \frac{p_0}{p_2} \text{ and } \frac{\alpha u'(c_1^*)}{\beta u'(c_2^*)} = \frac{p_1}{p_2}.$$

The marginal rate of substitution equals the relative prices.

Consumer Optimization: The Time Dimension

Irving Fisher (US, 1867-1947) was the first to recognize that the basic theory of consumer decision-making could be used to understand how to optimally allocate spending **intertemporally**, that is, over time, as well as how to optimally allocate spending across different goods in a **static**, or point-in-time, analysis.

Consumer Optimization: The Time Dimension

Following Fisher, return to the case of two goods, but reinterpret:

c_0 = consumption today

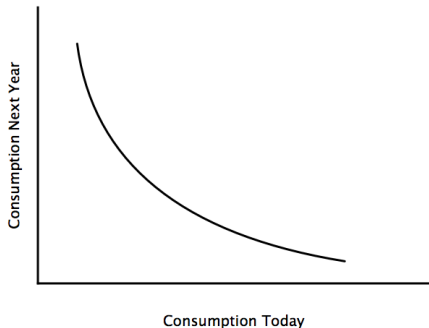
c_1 = consumption next year

Suppose that the consumer's utility function is

$$u(c_0) + \beta u(c_1),$$

where β now has a more specific interpretation, as the **discount factor**, a measure of patience.

Consumer Optimization: The Time Dimension



A concave utility function implies that indifference curves are convex, so that the consumer has a preference for a smoothness in consumption.

Consumer Optimization: The Time Dimension

Next, let

Y_0 = income today

Y_1 = income next year

s = amount saved (or borrowed if negative) today

r = interest rate

Consumer Optimization: The Time Dimension

Today, the consumer divides his or her income up into an amount to be consumed and an amount to be saved:

$$Y_0 \geq c_0 + s.$$

Next year, the consumer simply spends his or her income, including interest earnings if s is positive or net of interest expenses if s is negative:

$$Y_1 + (1 + r)s \geq c_1.$$