

Review Notes – Exchange General Equilibrium

- What are the benefits of exchange between two consumers?
 - Assumptions = 2 goods, 2 consumers, no production but initial endowments, initial MRS for both (that is, preferences/indifference curves/utility).
 - How can you tell if there is room for trade?
 - The Simple Edgeworth Exchange Box
 - Define the box with the assumptions given above.
 - What is a feasible allocation?
 - In the box how can we tell whether exchange is mutually beneficial?
 - If so, how long will trade continue?
 - What does Pareto Optimal mean?
 - What is the Contract Curve?
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- Market Exchange
 - What is a Walrasian auctioneer?
 - What defines the equilibrium?
 - When not in equilibrium, in which direction will prices change?
 - What are the budget lines for the two consumers?
 - Demand/Supply in the market
 - What is a person's gross demand?
 - What is a person's net demand?
 - A's gross demand of good 1 = $e_1^A = X_1^A - W_1^A$ (what is each term?)
 - B's gross demand of good 1 = $e_1^B = X_1^B - W_1^B$ (what is each term?)
 - $-e_1^A = A$'s gross supply of good 1 – why?; same for $-e_1^B$.
 - Equilibrium
 - Equilibrium requires that $-e_1^A = e_1^B$. Why? What does this mean?
 - Same for good 2.
 - When equilibrium conditions are not met, what happens?
 - What conditions hold at equilibrium? (Hint: compare MRS for both consumers).
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- Walras' Law
 - What are aggregate excess demands?
 - $z_1 = e_1^A + e_1^B$; $z_2 = e_2^A + e_2^B$
 - What is Walras' Law?
 - $p_1z_1 + p_2z_2 + p_3z_3 + \dots + p_nz_n = 0$ for all prices (not just equilibrium prices)
 - Why does Walras' law make sense?
 - What are the implications of Walras' law?

- In a two good world, excess demand in one market implies what about the other market?
- In a two good world equilibrium in one market implies what about the other market?
- In an n good world equilibrium in one market implies what about the other markets?
- In an n good world equilibrium in all but one market implies what about the other markets?
- According to Walras' law, which prices matter when consumers are making decisions in a market – nominal prices or relative prices?

- Welfare Economics

- First theorem of welfare economics

- All market equilibriums are Pareto optimal.
- Why does this make sense? How can it be shown graphically?
- What are the conditions under which this theorem holds?

- Second theorem of welfare economics

- Any Pareto optimal allocation is an equilibrium for some set of prices.
 - Why does this make sense? How can it be shown graphically?
 - What are the implications?
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