Two Conclusions from the Section

- Voluntary exchange is mutually beneficial
- Voluntary exchange results in efficiency

What are the benefits of exchange?

Assumptions of the model

- 2 consumers, 2 goods
- Initial endowments and MRS for both

What is an Edgeworth Exchange Box?

- Make sure you know how the box works – what is on each axis? How is each consumer’s consumption measured for each good?
- How are preferences for each consumer shown?
- How does the model demonstrate that voluntary trade is mutually beneficial?
- What is the contract curve?
- How does the contract curve show pareto efficiency (what’s that?)

Exchange using markets in an Edgeworth Box Diagram

- Both consumers choose their optimum consumption given endowments and market prices.
- If either market is not in equilibrium, then new market prices occur until reach equilibrium
- At equilibrium Qd=Qs for each good (i.e., neither excess demand or supply for either good).

What do we know about exchange from the model?

- First Theorem of Welfare Economics
  - All competitive market equilibriums are efficient (why?)

- Second Theorem of Welfare Economics
  - All efficient outcomes (allocation of goods between consumers) can be achieved by appropriately changing market conditions
    - What must be done to relative prices?
    - What must be done to endowments (i.e., redistribution of income)

- What are the implications of these two theorems?