Review Notes – General Equilibrium

- 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 Q_D=Q_S 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?