'General Equilibrium Theory'

DEFINITION of 'General Equilibrium Theory'

General equilibrium (GE) theory studies supply and demand fundamentals in an economy with multiple markets, with the objective of proving that all prices are at equilibrium.

The theory analyzes the mechanism by which the choices of economic agents are coordinated across all markets.

General equilibrium theory is distinguished from partial equilibrium theory by the fact that it attempts to look at several markets simultaneously rather than a single market in isolation.

The theory was first proposed by French economist Leon Walras in the 1870s, while the modern concept of general equilibrium was developed jointly by Arrow, Debreu and McKenzie in the 1950s.

- Walras was the first to give the GE approach vision, clarity and precision through the use of mathematical formulations
- Showed that the interdependent relationships between households and producers can trace all the direct, indirect and cross market effects when there is an exogenous change in a variable

Pure exchange model

- Pure exchange model: the special case of the GE model where all of the economic agents are consumers and nothing is neither appears nor disappears in the exchange model
- Free disposal: it doesn’t cost anything to dispose of (destroy) the good, hence the absorption of any additional amounts of inputs without any reduction in output is always possible

Pareto equilibrium