

ECON 4905
Cornell University
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Karl Shell

402D Uris Hall

www.karlshell.com

karl.shell@cornell.edu

ECON 4905 Spring 2016 Course Assistants

- Carlos Hernandez, clh265@cornell.edu
- Nicole Schmit, nrs77@cornell.edu
- Eric Schulman, ehs82@cornell.edu

False Dichotomy

- Real Economy

versus

- Nominal (i.e. financial) economy

Bank Runs

- Fundamental Driven
- Panic Driven

Role of Expectations

- Real contracts reduce the role of panic
- Financial contracts are more “efficient” but also allow for more volatility, including panic

General Equilibrium: Introduction to Static Pure Exchange

- Consumers, $h = 1, \dots, n$
- Commodities, $i = 1, \dots, l$
- Commodity consumed $x_h^i > 0$
 $x_h \in \mathbb{R}_{++}^{l,n}$
- Endowment $\omega_h^i > 0$
 $\omega_h \in \mathbb{R}_{++}^{l,n}$
- Preferences $u_h(x_h)$
- Prices $p = (p^1, \dots, p^i, \dots, p^l) \in \mathbb{R}_{++}^l$

Consumer Problem

$$\begin{aligned} & \max u_h(x_h) \\ \text{s. t. } & p \cdot x_h = p \cdot \omega_h \end{aligned}$$

or

$$\sum_h p^i x_h^i = \sum_h p^i \omega_h^i$$

or

$$\sum_h p^i (x_h^i - \omega_h^i) = 0$$

p is an equilibrium price vector if...

$$\sum_h x_h^i = \sum_h \omega_h^i \quad \text{for } i = 1, \dots, l$$

where x_h^i solves Mr. h 's problem for $h = 1, \dots, n$

- p exists
- See books by Arrow-Hahn and Balasko. See articles by Arrow-Debreu and McKenzie.
- Walrasian equilibrium

Welfare

- Every competitive equilibrium allocation $x \in \mathbb{R}_{++}^{l,n}$ is Pareto optimal
- Every Pareto optimal allocation can be supported as a competitive equilibrium allocation

Reflections

- Production
 - CRS easy
 - IRS inconsistent with CE
- Externalities
 - Failure of PO
- Non-convexities
 - Standard work week
 - King Solomon
 - Grand Tour versus in-depth visit
- Inter-temporal
 - Futures Markets versus “Money Markets”
- Uncertainty
 - Contingent claims versus Arrow securities