

## 4 The law of supply and demand in the proof of existence of general competitive equilibrium

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### Introduction

The proof of existence of a general competitive equilibrium is generally considered one of the most important and robust results of economic theory. The proofs of existence, which appeared in the 1950s, relied on results of topology, using a fixed-point theorem to demonstrate the existence of an equilibrium point. These proofs employ a suitable mapping, transforming points of a convenient set of prices and quantities onto itself. Our argument, in brief, is that the mappings used in these proofs are mathematically convenient but economically meaningless: they do not correspond to any plausible process of price variation.

To understand the mathematical strategy of the existence proofs, it may help to begin with a trivial example. In a one-commodity market, one would expect the change in price to reflect the excess demand for the commodity: price goes up when excess demand is positive, goes down when excess demand is negative, and remains unchanged at the market equilibrium point when excess demand is zero. In an  $n$ -commodity market, the mapping that determines price changes is more complex, but the underlying idea is similar: price changes are based on a function of prices and quantities, usually involving excess demand. An equilibrium is a vector of prices and quantities at which prices do not change because supply equals demand for all commodities – that is, a fixed point in the mapping which determines quantities and prices. If the sets and mappings have all the required topological properties, the mappings are guaranteed to have a fixed point, demonstrating the existence of general economic equilibrium.

The main objective of this chapter is to analyze the economic interpretations of the mappings involved in the proofs of existence. In the writings concerning the existence of equilibrium, the mathematical proof using a fixed-point theorem is accompanied by an economic interpretation of the relevant mappings. This interpretation evolved through time: in the 1950s it was considered that the mappings described a dynamic adjustment process, but later they were thought to express the law of supply and demand as a price variation rule without any reference to a dynamic

adjustment. This interpretation is commonly shared today in the relevant literature. The main finding of this chapter is that the second line of interpretation is as unacceptable as the first: in general, the mappings used in the proofs of existence contradict the price variation rule that is supposed to justify them from an economic standpoint.

If our analysis is correct, the single most important result of neoclassical theory in the past fifty years is a mathematical theorem devoid of any economic sense. Our results are a direct criticism of dominant economic theory from two points of view. The first pertains to the theoretical soundness and rigor of neoclassical theory. The second is more general, and concerns the relationship between mathematics and economic theory. These two aspects are of relevance today given that (i) on the basis of this purported logical coherence, neoclassical theory claims today to be the only available theoretical construct; and (ii) mathematization of economic theory is one of the most visible traits marking the evolution of the discipline during the past fifty years.<sup>1</sup> Our analysis relies on a thorough investigation of the mappings' behavior, something that surprisingly has attracted little or no attention since their appearance in the theoretical literature in the 1950s.

The first section describes the two economic interpretations of the mappings as they have evolved since the 1950s. In the second section we show that the three main mappings in the literature are inconsistent with the law of supply and demand.<sup>2</sup> In the third section we offer an explanation of the incompatibility between the mappings and the law of supply and demand. Our analysis leads to the question of whether a proof of existence of general equilibrium deprived of any economic meaning can be considered to be satisfactory. This important aspect of the problem is examined in our conclusion.<sup>3</sup>

### **Economic interpretations of the mappings used in the proof of existence of general equilibrium**

The economic sense ascribed to the mappings used in the proofs of existence has evolved over time. In the first writings it was ascertained, sometimes implicitly, that the mappings described a dynamic price adjustment process leading to general equilibrium. However, as the first negative results concerning stability came to light, the economic justification of the mappings was modified and restricted to the law of supply and demand as a rule of price changes without reference to the effects of these price variations on excess demands in the following period. In the following subsection we examine these interpretations in more detail.

**Interpretation of the proof of existence in terms of the dynamic adjustment process**

The 1956 papers by Nikaido and Debreu respectively stressed the idea that the mappings used in the proof of existence of equilibrium were the mathematical expression of a dynamic adjustment process. Prices changed according to the law of supply and demand as a function of excess demand's signs, while excess demands, in turn, are modified according to the relation  $\Delta z_{i,t+1}(p) = G_i(\Delta p_{i,t})$ . If such a process converges towards a position of equilibrium, it is defined as stable.

This view was already held by Gale (1955), whose paper suggests a close relation between the proof of existence and the law of supply and demand, defined as the mechanism by which "prices eventually regulate themselves to values at which supply and demand exactly balance, these being the prices at economic equilibrium" (ibid.: 87). The most important texts that pursue this interpretation are the following.

Nikaido uses the following mapping

$$\theta_i(p) = \frac{p_i + \max(z_i, 0)}{1 + \sum_j \max(z_j, 0)} \quad (i = 1, \dots, n)$$

where  $p_i$  and  $z_i$  are the price and excess demand of commodity  $i$  respectively. The economic interpretation of  $\theta(p)$  is advanced by Nikaido in the following terms:

The mapping  $\theta$  which appears in the proof of Theorem 16.6 may be interpreted as representing the behavior of the auctioneer who proposes a modification of prices responding to a nonequilibrium market situation.

(Nikaido 1968: 268)

Goods are exchanged in the market according to their prices. . . . If their demand and supply are not equal, current prices are induced to change under the influence of the "Invisible Hand". If new prices do not equate demand and supply, another round of price changes follows. Successive changes in prices with alterations in demand and supply continue until demand and supply are equated for all goods. In place of the Invisible Hand, we may suppose a fictitious auctioneer who declares prices  $p$  in the market. Participants in the market then cry out quantities they buy and sell. If their demand and supply do not match, the auctioneer declares a new set of prices  $p$ .  $\theta(p, x)$  defined above may be interpreted as an adjustment mechanism of demand and supply that associates new prices with current prices and excess supply  $x$ .

(Nikaido 1970: 321–22)

This interpretation was first put forward by Nikaido (1956). Consider a nonnegative price vector.

If the corresponding total demand  $X = \sum X_i$  does not match with the total available bundle  $A$ , the referee must try to set up a new price constellation which will be effective enough to let the individuals adjust their demands in such a way that the deviation of the total demand from  $A$  may be reduced. This scheme of the referee will be most effectively achieved by making the excess of the total monetary value  $PX$  to be paid by the individuals for  $X$  over their total available income  $PA$  as large as possible, i.e., by setting up a price constellation belonging to  $\chi(X) = \{P \mid P(X - A) = \max Q(X - A) \text{ over all } Q \in S^k\}$ . This function is multivalued and will be called the price manipulating function.

(Nikaido 1956: 139)

At the time, Debreu (1956) was stating the same thing,<sup>4</sup> mainly that his mapping of  $\text{Max } p \cdot z$  had "a simple economic interpretation: in order to reduce the excess demand, the weight of the price system is brought to bear on those commodities for which the excess demand is the greatest." He would later restate this as follows:

[A]n increase in the price of a commodity increases, or leaves unchanged, the total supply of that commodity. This hints at a tendency for an increase in the price of a commodity to decrease the corresponding excess demand. It prompts one, when trying to reduce positive excess demand, to put the weight of the price system on those commodities for which the excess demand is the greatest.

(Debreu 1959: 83)

According to a commonly held view of the role of prices, a natural reaction of a price-setting agency to this disequilibrium situation [i.e., a price vector with nonzero excess demands] would be to select a new price vector so as to make the excess demand  $F(p)$  as expensive as possible.

(Debreu 1974: 219)

According to Debreu (1982: 708), the economic interpretation of this mapping is quite clear, which may explain his allegiance to this mapping over the years:

the maximization with respect to  $p$  of this [excess demand] function agrees with a commonly held view of the way in which prices perform their market-equilibrating role by making commodities with positive excess demand more expensive and commodities with negative excess demand less expensive, thereby increasing the value of excess demand.

### **Interpretation of the proof of existence in terms of the law of supply and demand**

The previous interpretation found less support after the 1960s, especially after a paper by Scarf (1960). It became totally unacceptable in the 1970s after the negative results of Sonnenschein (1973), Mantel (1974), and Debreu (1974), who together resolutely demonstrated that the “commonly held view” on the “market-equilibrating role” of prices in the Arrow–Debreu model is utterly unjustified.

Explicit discussion of this interpretation is given by Hildenbrand and Kirman (1988: 106): “Even though an adjustment process may not converge, nevertheless a *fixed point*  $p^*$  of it exists.” This is why

If we confine ourselves to a fixed point of the adjustment process then this process, as such, has no real intrinsic economic content. We can then arbitrarily choose a process to suit our purpose. The only criterion is its mathematical convenience.

This does not mean that the mapping can remain economically meaningless, but that for its pertinence *in the proof of existence*, a price adjustment process does not have to be stable. The economic interpretation of the mappings in the proof of existence can be suitably based on the law of supply and demand, without any reference to a dynamic adjustment process.

This important point has not been completely grasped. A significant example can be found in the textbook by Mas-Colell *et al.* (1995). They use Debreu’s correspondence and state (ibid.: 586), “*This makes economic sense*; thinking  $f(\cdot)$  as a rule that adjusts current prices in a direction that eliminates any excess demand, the correspondence  $f(\cdot)$  as defined above assigns the highest prices to the commodities that are most in excess demand” (emphasis added). Such interpretation of the mapping in terms of an implicit reference to the stability of equilibrium is surprising.

In contrast, after presenting mapping  $\theta(p)$  (see p. 70), Varian (1992: 321) proposes a different interpretation: “This map has a *reasonable economic interpretation*: if there is an excess demand in some market, so that  $z_k(p) > 0$ , then the relative price of this good is increased” (emphasis added).

A straightforward assessment of this interpretation can be found in a book by Starr (1997: 101):

We establish sufficient conditions so that excess demand is a continuous function of prices and fulfills the Weak Walras’s Law. The rest of the proof involves *the mathematics of an economic story* [emphasis added]. Suppose the Walrasian auctioneer starts out with an arbitrary possible price vector (chosen at random, *crié au hasard*, in Walras’s

phrase) and then adjusts prices in response to the excess demand function  $Z(p)$ . He raises the price of goods,  $k$ , in excess demand,  $Z_k(p) > 0$ , and reduces the price of goods,  $k$ , in excess supply,  $Z_k(p) < 0$ . He performs this price adjustment as a continuous function of excess demands and supplies while staying on the price simplex. Then the price adjustment function  $\theta(p)$  is a continuous mapping from the price simplex into itself. From the Brouwer Fixed-Point Theorem, there is a fixed point  $p^0$  of the price adjustment function, so that  $\theta(p^0) = p^0$ .

And, furthermore: “The price adjustment function  $\theta$  raises the relative price of goods in excess demand and reduces that of goods in excess supply while keeping the price vector on the simplex.”

This statement leaves no doubt: the mapping used in the proof of existence is the expression of the law of supply and demand. The Walrasian auctioneer modifies prices according to the sign of excess demand, but the economic story is not affected by the effects of these price variations on excess demands.

Kreps’s remarks on mapping  $\theta(p)$  are as follows:

Take the numerator first. We add to the old price  $p_k$  a positive amount *if* there is excess demand for good  $k$  at price  $p$ . (This makes sense; raise the prices of goods for which there is too much demand). Then the denominator takes these new relative prices and rescales them so they sum to one again.

(Kreps 1990: 212)

In the absence of further comments, the reader is left with the impression that, as the numerator, the mapping  $\theta(p)$  makes economic “sense.” This presentation is misleading, as we will see in the next section.

### **Mappings and the law of supply and demand**

We will show that in the three most important mappings used in the proof of existence of a general competitive equilibrium, the price variation rule does not comply with the law of supply and demand, which is defined in the following subsection.<sup>5</sup> The mappings examined here are from Nikaido (1968, 1970, 1989), Arrow and Hahn (1971) and, finally, Arrow and Debreu (1954) and Debreu (1956, 1959).

#### ***The law of supply and demand***

In the words of Arrow (1981: 141), the “familiar law of supply and demand” states that the price of any one commodity increases when the demand for that commodity exceeds the supply, and decreases in the opposite case. If we take strictly positive prices, these can be measured in

terms of a *numéraire*.<sup>6</sup> We can also study prices expressed in terms of an abstract unit of account as elements of the  $n$ -dimension simplex  $\mathbf{p} \in S_n \subset R_n^+$ .

Let  $\Delta p_i = p'_i / \Sigma P'_i - p_i / \Sigma P_i$ , and let  $z_i(\mathbf{p})$  denote the excess demand function for commodity  $i$ . The law of supply and demand prescribes a price variation such that

$$\Delta p_i = 0 \text{ if } z_i(\mathbf{p}) = 0, \text{ or if } z_i(\mathbf{p}) < 0 \text{ with } p_i = 0$$

$$\Delta p_i \cdot z_i(\mathbf{p}) > 0 \text{ in all other cases}$$

This is the price variation rule that lies behind the contemporary economic interpretation of the mappings used in the proof of existence. But as we show in the following subsection, the mappings do not respect this price variation rule.

### Nikaido's mapping

Nikaido (1968, 1970, 1989) proves the existence of a general equilibrium by using the mapping already mentioned in the previous section:

$$\theta_i(p) = \frac{p_i + \max(z_i, 0)}{1 + \Sigma_j \max(z_j, 0)} \quad (i = 1, \dots, n)$$

where  $p_i$  and  $z_i$  are the price and the excess demand of commodity  $i$  respectively. The mapping transforms points in the unit simplex  $P_n$  into price vectors  $\mathbf{p}$  contained in the unit simplex. Each element of the unit simplex  $P_n$  is a normalized vector of prices such that  $\Sigma_i p_i = 1$ . Homogeneity of degree 0 of the excess demand and supply functions in all prices allows the search for equilibrium price vectors to be limited to the unit simplex of  $R_n$ .

To determine whether mapping  $\theta_i(\mathbf{p})$  satisfies the law of supply and demand, we will examine successively the following three cases:  $z_i > 0$ ,  $z_i < 0$ ,  $y z_i = 0$ .

### Positive excess demand

In the case of  $z_i > 0$ , the law of supply and demand specifies an increase the price of commodity  $i$ . This implies  $\theta_i(\mathbf{p}) > p_i$  and, in turn, according with mapping  $\theta_i(\mathbf{p})$ , this means that we must have

$$p_i + z_i > p_i [1 + \Sigma_j \max(z_j, 0)]$$

$$z_i > p_i [\Sigma_j \max(z_j, 0)]$$

$$z_i > p_i z_i + p_i \cdot \Sigma_{j \neq i} \max(z_j, 0)$$

In this case, because  $p_i < 1$ , then  $z_i \cdot p_i < z_i$ . The inequality is verified if for all other commodities  $j \neq i$ , excess demands are negative or null. If one commodity  $j \neq i$  has a positive excess demand, then the condition may not be satisfied. Thus,  $\theta_i(\mathbf{p})$  is not consistent with the law of supply and demand.

### Negative excess demand

If  $z_i < 0$ , the price of commodity  $i$  must decrease:  $\theta_i(p) < p_i$ . Because  $\max(z_i, 0) = 0$ , this inequality implies

$$p_i < p_i + p_i \cdot \Sigma_j \max(z_j, 0)$$

This condition is verified if there is at least one commodity  $j \neq i$  with a positive excess demand, which is guaranteed by Walras's law. In this case, the price adjustment rule expressed by the mapping  $\theta_i(\mathbf{p})$  appears to be the law of supply and demand. However, the price variation for good  $i$  depends not only on the sign of  $z_i$ , but also on the presence of positive excess demands for other goods, something not dictated by the law of supply and demand. Thus, if the mapping appears to be consistent with the law of supply and demand, it is by virtue of Walras's law.

### Zero excess demand

When  $z_i = 0$ , the law of supply and demand ordains that price  $p_i$  must remain unchanged, thus  $\theta_i(\mathbf{p}) = p_i$ . But once again, we have problems to interpret mapping  $\theta_i(\mathbf{p})$  as consistent with the law of supply and demand. What are the conditions under which this equality is verified? Because  $\max(z_i, 0) = 0$ , we have

$$p_i = p_i + p_i \cdot \Sigma_j \max(z_j, 0)$$

This condition is verified if the second term in the right-hand side is zero, and this is the case when for all  $j \neq i$ ,  $z_j \leq 0$ . Because of Walras's law, this is not possible except in general equilibrium. Outside of *general* equilibrium, there exists at least one commodity  $j \neq i$  with positive excess demand. The price adjustment rule in mapping  $\theta_i(\mathbf{p})$  carries with it the reduction of price  $p_i$ . This is in contradiction with the law of supply and demand.

### The Arrow-Hahn mapping

For the  $i$ th component, the mapping used by Arrow and Hahn (1971) is

$$T_i(p) = \frac{p_i + \max(-p_i, z_i(p))}{1 + \Sigma_j \max(-p_j, z_j(p))}$$

Although it may be somewhat monotonous, an analysis similar to the previous one is required.

#### Positive excess demand

The price  $p_i$  must rise – that is,  $T_i(\mathbf{p}) > p_i$ . This can be expressed as follows:

$$z_i(\mathbf{p}) > p_i \cdot z_i(\mathbf{p}) + p_i \cdot \sum_{j \neq i} \max(-p_j, z_j(\mathbf{p}))$$

If there exists a commodity  $j \neq i$  with a positive excess demand, the above condition is verified only if the value of  $z_i(\mathbf{p})$  is sufficiently large to prevail over the positive value of  $z_j(\mathbf{p})$ . The price variation rule imposed by mapping  $T(\mathbf{p})$  does not respect the law of supply and demand.

#### Negative excess demand

Price  $p_i$  must decrease – that is,  $T_i(\mathbf{p}) < p_i$ . Hence

$$p_i + \max(-p_i, z_i(\mathbf{p})) < p_i [1 + \sum_j \max(-p_j, z_j(\mathbf{p}))]$$

$$\max(-p_i, z_i(\mathbf{p})) < p_i \cdot \sum_j \max(-p_j, z_j(\mathbf{p}))$$

Obviously, the possibility of reducing the price of commodity  $i$  depends on the absolute values of  $p_i$ ,  $z_i(\mathbf{p})$ ,  $p_j$  and  $z_j(\mathbf{p})$ . Thus, the above inequality may not be verified. According to the values of these variables, we can obtain  $T_i(\mathbf{p}) > p_i$ ; this means that, in spite of the excess supply for commodity  $i$ , the price imposed by  $T_i(\mathbf{p})$  may increase.

#### Zero excess demand

When  $z_i(\mathbf{p}) = 0$ , we should have  $T_i(\mathbf{p}) = p_i$ . Thus

$$p_i + \max(-p_i, z_i(\mathbf{p})) = p_i [1 + \sum_j \max(-p_j, z_j(\mathbf{p}))]$$

$$p_i = p_i + p_i \cdot \sum_j \max(-p_j, z_j(\mathbf{p}))$$

Equality  $T_i(\mathbf{p}) = p_i$  is verified only if  $z_i(\mathbf{p}) = 0$  and if  $z_j(\mathbf{p}) = 0$  for all commodities  $j \neq i$ . This is not what the law of supply and demand states.

#### Debreu's approach

Debreu (1959) considers a price vector  $\mathbf{p}$  in the unit simplex  $P_n = \{p \in R_n^+ | p \geq 0, \sum_i p_i = 1\}$ , and the set of possible excess demands  $Z$ . He defines an aggregate excess demand correspondence  $\zeta(\mathbf{p}) = \xi(\mathbf{p}) - \eta(\mathbf{p}) - \{\omega\}$  (where  $\xi(\mathbf{p})$  is the aggregate demand correspondence,  $\eta(\mathbf{p})$  the aggregate supply correspondence and  $\{\omega\}$  the vector of

initial endowments of the economy) which associates to each price vector  $\mathbf{p} \in P_n$  a vector  $\mathbf{z} \in Z$ . A new correspondence  $\mu(\mathbf{z})$  then associates to  $\mathbf{z}$  a vector of prices within  $P_n$  such that  $\mathbf{p} \cdot \mathbf{z}$  is maximized:

$$\mu(\mathbf{z}) = \{p \in P_n | \mathbf{p} \cdot \mathbf{z} = \max P \cdot \mathbf{z}\}$$

Debreu then defines a new correspondence  $\psi$  of set  $P_n \times Z$  on itself  $\psi(\mathbf{p}, \mathbf{z}) = \mu(\mathbf{z}) \times \zeta(\mathbf{p})$ . This mapping  $\psi(\mathbf{z}, \mathbf{p})$  implies that to each vector  $\mathbf{z}$  a price vector  $\mathbf{p}$  is associated in order to maximize  $\mathbf{p} \cdot \mathbf{z}$ . This is what Debreu (1959: 83) calls “the central idea in the proof,” which is then described in the following terms: “Let  $H$  be the set of commodities for which the component of  $\mathbf{z}$  is the greatest. Maximizing  $\mathbf{p} \cdot \mathbf{z}$  on  $P_n$  amounts to taking  $\mathbf{p} \geq 0$  such that  $p_h = 0$  if  $h \notin H$ , and  $\sum_{h \in H} p_h = 1$ .”

The price adjustment rule is the following: the commodity  $k$  with the highest excess demand in vector  $\mathbf{z}$  is chosen, such that  $z_k \geq z_i, \forall z_i \in Z, i \neq k$ . The new price vector resulting from correspondence  $\mu(\mathbf{p})$  has all of its components  $p_{i \neq k} = 0$  and component  $p_k = 1$  (because no linear combination of the price vector and the excess demand vector results in a higher value than  $p_k \cdot z_k$ ). That is to say, outside of the fixed point, the prices of commodities with positive excess demands (at positive prices) inferior to the largest excess demand are reduced to zero. Their prices are brought to zero for the simple reason that their excess demand is not superior to the other excess demands.

An alternative approach to examine this is as follows. Let  $\mathbf{p}$  be a price vector,  $\mathbf{z}$  the vector of excess demands calculated at these prices and  $\mathbf{p}'$  the new price vector resulting from the law of supply and demand. Necessarily we have  $\mathbf{p}' \cdot \mathbf{z} > \mathbf{p} \cdot \mathbf{z}$ . The consequence of this law is that, outside the fixed point, the aggregate value of excess demand must increase. But the economic meaning of this result stems from the same reason advanced by Debreu: the increase (or decrease) of the prices of commodities with positive (or negative) excess demand. Thus, contrary to Debreu's assertion, the value of  $\mathbf{p} \cdot \mathbf{z}$  cannot be a maximum without contradicting the law of supply and demand. This is self-evident: to reach this maximum, the prices of commodities with excess demands that are both positive and inferior to the largest must be reduced to zero; in the case that several commodities have the same largest excess demand, all of their prices, except one, can be reduced to zero, reserving  $p = 1$  for the exception.<sup>7</sup> There is here a brazen contradiction with the law of supply and demand.<sup>8</sup>

These considerations should help explain Arrow's reservations: “this rule is somewhat artificial” (1972: 219) and, later, Debreu's (1989: 134):

Maximizing the function  $\mathbf{p} \rightarrow \mathbf{p} \cdot \mathbf{z}$  over  $P_n$  carries to one extreme the idea that the price-setter should choose high prices for the commodities that are in excess demand, and low prices for the commodities that are in excess supply.

But these calls for caution are useless: the mapping that maximizes  $\mathbf{p} \cdot \mathbf{z}$  is *totally* artificial, and it does not carry to one extreme the law of supply and demand, but utterly *contradicts* it.<sup>9</sup>

### The special case of a two-commodity economy

Consider a two-commodity economy with  $p_1, p_2$  and  $z_1, z_2$ , the prices and excess demands of commodities 1 and 2 respectively, and suppose that all customary conditions for the existence of equilibrium are verified. By virtue of Walras's law,  $\mathbf{p} \cdot \mathbf{z} = 0$ , and thus  $z_1 \cdot z_2 < 0$ .

Consider Nikaido's correspondence:

$$\theta_i(\mathbf{p}) = \frac{p_i + \max(z_i, 0)}{1 + \sum_j \max(z_j, 0)}$$

when  $z_1 > 0$ . Because  $z_2 < 0$ ,  $\theta_1(\mathbf{p}) > p_1$  is true if  $z_1 > p_1 z_1$ , the last inequality holds since  $p_1 < 1$ . If  $z_1 < 0$ , we have  $p_1 z_2 > 0$ , which is equivalent to  $\theta_1(\mathbf{p}) < p_1$ . Since these inequalities are verified, the price of commodity 1 increases in the first case and decreases in the second.

We arrive at the same conclusion considering the correspondence of Arrow–Hahn:

$$T_i(\mathbf{p}) = \frac{p_i + \max(-p_i, z_i(\mathbf{p}))}{1 + \sum_j \max(-p_j, z_j(\mathbf{p}))}$$

Suppose  $z_1 > 0$ . Because  $p_1 < 1$ , we have  $(1 - p_1)z_1 > 0$ . Since  $z_2 < 0$ ,  $p_1[(\max(-p_2, z_2)) < 0$ , thus  $(1 - p_1)z_1 > p_1[(\max(-p_2, z_2))]$ . The conditions for increasing  $p_1$  are satisfied.

Consider now  $z_1 < 0$ . Let  $u_1 = \max(-p_1, z_1)$ . Then  $(1 - p_1)u_1 < 0$ ,  $z_2 > 0$  and  $\max(-p_2, z_2) = z_2$ . Therefore,  $p_1(\max(-p_2, z_2)) > 0$  and  $(1 - p_1)u_1 < p_1(\max(-p_2, z_2))$ . Thus the conditions for the reduction of  $p_1$  are verified.

Finally, the price adjustment rule imposed by Debreu mapping which maximizes the value of  $\mathbf{p} \cdot \mathbf{z}$  yields the following result. If  $z_1 > 0$ , we have  $z_2 < 0$  and  $p_1$  is increased until it equals 1. If  $z_1 < 0$ ,  $p_1$  is reduced until it becomes 0. In the special case of a two-commodity economy, the property  $\Delta p_i \cdot z_i(\mathbf{p}) > 0$  is verified by virtue of Walras's law, and *not* by the law of supply and demand.

### Synthesis of results

- 1  $z_i > 0$ 
  - (a)  $z_i > 0 \Rightarrow p_i$  increases
  - (b)  $p_i$  increases  $\Rightarrow z_i > 0$

For correspondences  $\theta_i(\mathbf{p})$  and  $T_i(\mathbf{p})$ , statement (a) is false and (b) is true. Therefore,  $z_i > 0$  is the necessary condition, but not sufficient, for the increment in  $p_i$ .

- 2  $z_i < 0$ 
  - (a)  $z_i < 0 \Rightarrow p_i$  decreases
  - (b)  $p_i$  decreases  $\Rightarrow z_i < 0$

For correspondence  $\theta_i(\mathbf{p})$ , statement (a) is true by virtue of Walras's law, but statement (b) is false. Thus,  $z_i < 0$  is the sufficient condition, but not the necessary condition for the reduction of  $p_i$ .

For correspondence  $T_i(\mathbf{p})$ , both statements are false:  $z_i < 0$  is neither the sufficient nor the necessary condition for the reduction of  $p_i$ .

- 3  $z_i = 0$ 
  - $z_i = 0 \Rightarrow p_i = \theta_i(\mathbf{p})$
  - $p_i = \theta_i(\mathbf{p}) \Rightarrow z_i = 0$

For correspondence  $\theta_i(\mathbf{p})$ , (a) is false, but (b) is true only if  $z_j = 0$  for all  $j \neq i$ . Thus, we have that  $z_i = 0$  is a sufficient but not a necessary condition for  $p_i = 0$ .

For correspondence  $T_i(\mathbf{p})$ , (a) and (b) are both false. Thus  $z_i = 0$  is neither the necessary nor the sufficient condition for  $T_i(\mathbf{p}) = p_i$ .<sup>10</sup>

### The law of supply and demand and the normalization of prices

The nature of the problem occupying our attention is clearly revealed if we follow the different stages of the construction of the mappings as exemplified in Arrow and Hahn's (1971: 25–27) procedure. The starting point is a two-commodity economy for which four price-variation rules, valid also in the general case of an  $n$ -commodity economy, are adopted:

- (i) Raise the price of the good in positive excess demand.
- (ii) Lower or at least do not raise the price of the good in excess supply, but never lower the price below zero.
- (iii) Do not change the price of a good in zero excess demand.
- (iv) Multiply the resulting price vector by a scalar, leaving relative prices unchanged, so that the new price vector you obtain is in  $S_n$ .

(Arrow and Hahn 1971: 25–27)

In the construction of the correspondence,

we first seek for a continuous function  $M_i(\mathbf{p})$  with the following three properties:

- (1)  $M_i(\mathbf{p}) > 0$  if and only if  $z_i(\mathbf{p}) > 0$
- (2)  $M_i(\mathbf{p}) = 0$  if  $z_i(\mathbf{p}) = 0$
- (3)  $p_i + M_i(\mathbf{p}) \geq 0$

It is intended that  $M_i(\mathbf{p})$  represent an adjustment to an existing price so that a price vector  $\mathbf{p}$  is transformed into a new price vector with components  $p_i + M_i(\mathbf{p})$ .

(Arrow and Hahn 1971: 25–27)

There are correspondences with properties P1–P3, for example:

$$M_i(\mathbf{p}) = \max(-p_i, k_i \cdot z_i(\mathbf{p})), \text{ where } k_i > 0.$$

[I]f we interpret  $(p_i + M_i(\mathbf{p}))$  as the  $i$ th component of the new price vector that the mapping produces, given  $\mathbf{p}$ , the procedure for finding these new prices satisfies the rules discussed earlier. However, while all  $(p_i + M_i(\mathbf{p}))$  are certainly non-negative, there is nothing to ensure that they will add up to one. In other words, ... there is no reason to suppose that  $(\mathbf{p} + \mathbf{M}(\mathbf{p}))$  is in  $S_n$  when  $\mathbf{p}$  is in  $S_n$ . Since we seek a mapping of  $S_n$  into itself, we must modify the mapping.

(Arrow and Hahn 1971: 25–27)

This is where the price normalization implied by rule (iv) intervenes and the result is correspondence

$$T(\mathbf{p}) = \frac{\mathbf{p} + \mathbf{M}(\mathbf{p})}{[\mathbf{p} + \mathbf{M}(\mathbf{p})]e}$$

According to Arrow and Hahn, this is an “obvious way” of solving the difficulty they identified (see also Arrow 1968: 117). But this assertion is incorrect, because rule (4) modifies the initial mapping so as to make it *noncompliant with the first three rules*.

Our analysis of the most important mappings used in the proof of existence of GCE (pp. 74–77) reveals that under these conditions, the adjustment of price  $p_i$  does not depend so much on the sign of  $z_i(\mathbf{p})$  as on the relation between  $z_i(\mathbf{p})$  and the other  $z_j(\mathbf{p})$  for  $j \neq i$ . It is the relative weight of  $z_i(\mathbf{p})$  within the set of excess demands that has an influence on the direction of the change in  $p_i$ . This is the source of the strange price adjustment mechanism established by these correspondences: in a market  $i$  with positive excess demand, the price can increase or decrease depending on the relative importance of the excess demands on the other markets.<sup>11</sup> The interdependencies acting on the direction of the price variation of the mappings are a direct consequence of the normalization of the price system.

The predicament can be stated as follows. *In order to avoid falling outside of the price simplex, one leaves the law of supply and demand*: we either have a fixed point and the mapping is devoid of economic sense; or we use a correspondence with an economic meaning, but lose the fixed point.<sup>12</sup>

## Conclusion

We can now summarize our key findings. The proofs of existence for a general competitive equilibrium are associated with an economic interpretation of the mappings used in the demonstration. We have shown that the interpretation of price variation generated by these mappings in terms of the law of supply and demand cannot be accepted.<sup>13</sup> With greater strength, this conclusion can be applied to interpretations in terms of a dynamic adjustment process.

The point is not a defense or critique of the law of supply and demand as it is conceived and presented in the framework of general equilibrium theory. What we are simply stating is that, first, this definition is unanimously accepted. Second, the authors we consider here claim that the mappings used in their proof of existence of equilibrium obey this law. Third, our analysis reveals that this is not the case. As a consequence, there is a difficulty in the proof of existence insofar as that which is actually accomplished does not correspond with what is claimed to be achieved.

It could be thought that because an “abstract economy” intervenes in the proof of existence, there is no need to provide an economic interpretation of the mappings. In point of fact, the economic interpretation of the mappings is described and justified precisely as the concept of an abstract economy is introduced by Arrow and Debreu. In their first proof of existence, advanced in 1954, which relies on the construction of an abstract economy, these authors propose an economic interpretation of their mapping precisely in terms of the law of supply and demand. The insistence on resorting to economically meaningful mappings is present in all of the relevant works of Arrow (including his conference on the occasion of the Nobel Prize), Debreu and Hahn. Debreu himself advances as the central justification of his excess demand approach the fact that it has a clear and simple economic interpretation.<sup>14</sup>

These authors’ approach is quite correct, for the abstract economy they build is not isolated from the original economy, and the fundamental laws of the latter apply to the former. Or to put it in other terms, it is inconceivable that the rules that apply in the abstract economy contradict the laws of the original economy. The fact that we can deal with an “abstract” economy does not eliminate the fact that we are dealing with an “economy” subject to economic “laws”. This is precisely the reason why it is possible to make the “return trip” from the abstract to the original

economy in the attempt to complete the proof of existence of equilibrium. Thus, the construction of an “abstract economy” in no way justifies the idea that the mappings can be exempt of an economic interpretation.<sup>15</sup>

We thus arrive at the following crossroads. If it is considered that only the mathematical properties of the mappings are necessary, quite independently of their economic meaning, it is difficult to understand why claims to the contrary are so abundant. If the mappings are considered to have an economic meaning, as it is ascertained, then the use of mappings that lack such an economic meaning entails the lack of pertinence of the proof of existence from the economic viewpoint, whatever the mathematical properties of the intervening sets and mappings. Clarifying this situation is important because, due to the shortcomings of stability theory, the existence theorems play an all-important role in economic theory.

From our standpoint, we consider that if, mathematically, an economic equilibrium can be represented as a fixed point of a suitable mapping, it does not follow that every fixed point is an economic equilibrium. This depends on the nature of the intervening variables and the definition of the mapping used in the proof of existence of equilibrium. Given the nature of the task at hand, the rest point determined by the fixed-point theorem must be an economic rest point representing a state of the economy in which economic forces intervening in price formation are in balance. The search for a mapping with an economic meaning is thus a legitimate concern. It would be rather surprising to use a mapping that did not represent the law of supply and demand to demonstrate, by means of its fixed point, the existence of an equilibrium between supply and demand.

In the mappings used, the excess demand  $z_i$  generates a variation of price  $p_i$  that contradicts the law of supply and demand. This is true regardless of the sign of excess demand (positive or negative), as well as when excess demand is zero. If, in the fixed point, no individual prices change, this is not by virtue of the law of supply and demand: price  $p_i$  does not change only when  $z_i = 0$  and  $z_j = 0$ , for all  $j \neq i$ . The excess demand  $z_i = 0$  is a necessary condition for keeping  $p_i$  unchanged, but it is not a sufficient condition, contrary to what is stated by the law of supply and demand. Thus, whichever point over the mappings’ domains is considered, such mappings are deprived of the economic meaning commonly attributed to them.

We reject the idea that *only* the mathematical properties of the proof should be taken into account. We have not encountered this proposition under the penmanship of the founders of contemporary general equilibrium theory, nor in later presentations. On the contrary, as we have seen, the authors have explicitly described the economic interpretation that they claim is inherent to the mappings they use. The task now is to draw out the consequences of the fact that, since the said mappings do not have the meaning attributed to them, the main result of the modern neoclassical theory is a mathematical theorem devoid of economic sense.

## Notes

- 1 A recent, and lively, discussion of the relation between economic theory and mathematics can be found in d’Autume and Cartelier (1997).
- 2 We do not examine the proofs of existence that rely on the results of welfare theory (Arrow and Hahn 1971), nor do we consider the existence results that rely on assumptions of differentiability of individual supply and demand functions. It is true that in the context of general equilibrium theory, global analysis represents an approach that is closer to the older traditions (Smale 1989). Nonetheless, the crucial point for our purposes is that work along these lines (Smale 1981; Mas-Collel 1985) imposes assumptions that are more restrictive than those required by Arrow–Debreu models. Thus, our chapter is concerned with proofs of existence of general equilibrium in the more general setting.
- 3 We assume the reader is familiar with the techniques used in the proof of existence of general competitive equilibrium.
- 4 As to Debreu’s approach, Hildenbrand (1983: 20) describes it as follows: “Debreu used another method of proof in his further work on competitive equilibrium analysis . . . i.e. the ‘excess demand approach’ because he thought that this method of proving existence is more in line of traditional economic thinking.”
- 5 This carries negative implications for the two economic interpretations described in the previous section, for the economic interpretation based on a dynamic price adjustment process rests on the assumption that the law of supply and demand is respected by the mappings.
- 6 We are not concerned here by the effects of the choice of *numéraire* on stability.
- 7 “[T]otal prices must add up to one, but this total is to be distributed only over those commodities with maximum excess demand” (Arrow 1972: 219). The mapping used by Arrow and Debreu (1954) and Debreu (1959) finds its origins in the hypotheses of the maximum theorem. According to Takayama (1988: 254), although Debreu used the maximum theorem in his *Theory of Value* (1959) in order to establish the upper semicontinuity of the demand and supply functions, no explicit mention of the literature on the theorem (in particular, the seminal work of C. Berge) was made by him. Debreu (1982) does make an explicit reference to Berge’s maximum theorem. This theorem can be used to prove the upper semicontinuity of multivalued correspondences, and is employed to establish this property for the supply and demand correspondences. Although the correspondence  $\max \mathbf{p} \times \mathbf{z}$  does exhibit this property, the difficulty is that in order to ensure the property of upper semicontinuity, the proof relies on a correspondence lacking a reasonable economic meaning. The predicament here is that the property of upper semicontinuity is guaranteed at the cost of rendering the correspondence incompatible with the law of supply and demand.
- 8 In Arrow and Debreu (1954: 275), a “market participant” with a price-setting role is introduced. This agent, renamed by Debreu (1982: 134) the “fictitious price-setting agent” and endowed with a “utility function” that “is specified to be  $\mathbf{p} \times \mathbf{z}$ ”, chooses a price vector  $\mathbf{p}$  in  $\mathbf{P}$  for a given  $\mathbf{z}$  and “receives  $\mathbf{p} \times \mathbf{z}$ ”. As we have seen, this new price vector  $\mathbf{p}$  maximizes  $\mathbf{p} \times \mathbf{z}$ , which implies, outside the fixed point, that all prices are zero except the price of the commodity with the largest excess demand. Arrow and Debreu (1954: 274–75) continue: “Suppose the market participant does not maximize instantaneously but, taking other participants’ choices as given, adjusts his choice of prices so as to increase his pay-off. For given  $\mathbf{z}$ ,  $\mathbf{p}\mathbf{z}$  is a linear function of  $\mathbf{p}$ ; it can be increased by increasing  $p_h$  for those commodities for which  $z_h > 0$ , decreasing  $z_h < 0$  (provided  $p_h$  is



not already zero). But this is precisely the classical ‘law of supply and demand’, and so the motivation of the market participant corresponds to one of the elements of the competitive equilibrium.” This behavior, which is totally artificial, reinforces our conclusion. Instead of abruptly contradicting the law of supply and demand, the contradiction is obtained gradually. In this case, the law holds as long as the market participant does not maximize his utility function, and ceases to hold when this agent at last behaves according to the rationality that is assigned to him.

- 9 Nikaido (1968: 267) also presents this type of correspondence as an alternative way to approach the proof of existence of a competitive equilibrium. Correspondence  $\eta$  yields equilibrium solutions for the excess-supply correspondence  $\chi$  as fixed points of mapping:

$$f(u, p) = \chi(p) \times \eta(u): \Gamma \times P_n \rightarrow 2^{\Gamma \times P_n}$$

where  $u$  represents the vector of excess supplies, and  $\eta(u) = \{r \mid \text{minimizes } u \cdot q \text{ for all } q \in P_n\}$ . Our remarks on the Arrow–Debreu mapping apply *mutatis mutandis* to this approach to the proof of existence of a general competitive equilibrium.

- 10 If we consider relative prices of the form  $p_i/p_j$ , then

- (a)  $z_i > 0$  and  $z_j < 0$  then  $p_i/p_j$  increases;  
 (b)  $p_i/p_j$  increases, then  $z_i > 0$  and  $z_j < 0$

Whichever correspondence is considered,  $\theta_i(p)$  or  $T(p)$ , (a) is true and (b) is false. Thus,  $z_i > 0$  and  $z_j < 0$  is the sufficient condition, but not the necessary condition for the increase of  $p_i/p_j$ . The same conclusion applies in the opposite case ( $z_i < 0$  and  $z_j > 0$ ). Evidently, the comparison of “relative prices” does not furnish indications about the state of supplies and demands which, through these correspondences, have generated the price variation. The only thing it reveals is that if, for example,  $\theta_i(p)/\theta_j(p) > p_i/p_j$ , then  $z_i > z_j$ . But these excess demands can be both positive or both negative.

- 11 Note that this rule which brings to bear the relative weight of excess demands in the other markets on the direction of price variations in one market has nothing to do with the type of interdependencies commonly considered in general equilibrium theory, such as substitution and income effects. The latter concern the effects of the changes in the prices on the excess demands and not the effects of changes in excess demands on prices. None of these interdependencies can explain why the price of one commodity decreases (increases) when its excess demand is positive (negative).
- 12 Would it be possible to avoid this predicament? This would imply seeking a fixed point in a correspondence consistent with the law of supply and demand, for example  $p_i + M_i(p)$ . To our knowledge this has not been attempted. The reason for this probably lies in the additional restrictions that would have to be imposed on the supply and demand correspondences. As is well known from the work of Sonnenschein, Mantel, and Debreu, there is no economic justification for such restrictions. Moreover, such additional constraints on these correspondences would limit the generality that is commonly attributed to the proof of existence in Arrow–Debreu models.
- 13 It is straightforward to construct numerical examples in which the relevant assumptions hold (Walras’s law and prices belong to the unit simplex) but where price changes contradict the law of supply and demand.
- 14 In their classic 1954 paper, Arrow and Debreu set the precedent as their concept of an abstract economy includes the market participant, his payoff function ( $\max p \times z$ ) and the economic behavior of consumers and producers. Debreu’s survey article (1982: 708) is quite explicit on this point, for in order to

cast the abstract economy “in the form of the general model of a social system,” Debreu introduces a fictitious market agent whose role is to choose a price vector  $p \in P$  and whose utility function depends on choosing  $p$  so as to make excess demand as expensive as possible.

- 15 The construction of an abstract economy implies, among other things, modifying the original possibility sets of individual producers and consumers in order to ensure boundedness. This property is in turn required to ensure that individual supply and demand functions are defined. Chapter 2 by Nadal, on the building blocks of general equilibrium theory, examines the shortcomings of this procedure.

# Index

- active fiscal policy 143  
 adjustment process 21, 31n, 50, 70, 135, 195; dynamic 68–70, 83n  
 advertising 89, 92, 96  
*The Affluent Society* 89  
 agents: agency dimension 198; awareness 198; denied capabilities 195  
 aggregate behavior 21; demand 16, 18, 22; economic behaviour 18; incomes 30  
 aggregate feasibility set 109; production function 107  
 anti-inflation objectives 147n  
 Arrow–Debreu model 15, 19, 20, 33, 37, 43, 46, 55–7, 64–6  
 asocial individualism 87; failure of 88  
 assets; in local currency 136; rate of return 65  
 auctioneer 63, 70, 72–3, 108, 195  
 automatic adjustment process 134, 138
- balance of trade 145, 178; adjustment 147n; deficit 135; payments 157  
 bargaining *see* game theory  
 barter economy 35, 48, 50, 56, 64; excess demands matrices 51–4; indirect barter 52–3  
 bounded rationality 28; consumers 41; producers 40  
 Berge’s maximum theorem 83n  
 Bilateral trades 49, 51  
 boundedness 40, 43, 100, 108, 109  
 bounded rationality 28, 30  
 Brouwer Fixed-Point Theorem 73  
 budget constraints 39, 41–2, 47, 49, 56, 64, 66n  
 butterfly effect *see* nonlinear dynamics
- Cambridge equation 58
- capital account 137  
 capital asset value 107; factor growth rate 114n; goods 110; increase in 101; investment 114n; stock 107  
 capital flight 154, 155, 163  
 capital flows 136, 138–9, 140–1, 180  
 capital-intensive imports in US 157; production technologies 114n, 156  
 cardinal utility 7  
 centralized accounting system 55, 64; transactions 53, 56  
 chaos theory *see* nonlinear economic systems  
 choice of technique paradigm 104, 108, 109, 110, 111  
 closedness 43, 44, 47n, 100  
 commodities expressed in numbers 34–6  
 commodity: money 54; orientation 87, 94, 97; prices 102; production methods 106; space 25, 26, 31n  
 comparative advantage, dynamic 150, 158; static 150, 152–3, 158  
 comparative statics 104, 108, 146, 180  
 competition 106; foreign 160; role of 193  
 competitive markets 3, 108, 149, 150  
 competitive equilibrium 43, 108, 109; complexity theory *see* nonlinear economic systems  
 computable general equilibrium (CGE) model 168; assumptions 174; inbuilt obsolescence 173; high cost 172–3; misleading forecasts 177–8  
 conservation in economic theory 25  
 conspicuous consumption 88–90, 93  
 consumer behavior 1, 11, 18, 22, 86, 92; drives 87; theory 88, 94; preferences 16, 22, 30; satisfaction 92–3
- consumer indifference curves 90  
 consumption allocations 43, 64; individual 49; loan model 60; profile 63  
 consumption analysis 94; ceremonial aspect 88  
 consumption of characteristics 95  
 contingent valuation 120, 124, 129, 130; surveys 122, 128, 129  
 contraction of demand 140  
 convergence 2, 102, 106, 146  
 convexity 36, 43, 47n, 100  
 coordination of individual actions 198  
 cost–benefit analysis 118, 124–5, 127, 130  
 cross-market access 142  
 crowding out 89
- deceleration of prices 50  
 decentralized market 48, 108, 195  
 deductive models of the economy 178–9  
 demonstration effect 88, 90  
 deregulation 134, 136  
 devaluation 136, 137  
 deterministic nonlinear models 29  
 developing countries 111–12, 117, 152, 154, 156, 161–3; farmers 164; trade policies 160  
 development economic strategy 99, 100, 153, 156, 165  
 disequilibrium opportunities 194, 198  
 distortions 7; relative price of labor 99; relative prices 113n; world food markets 164  
 domestic consumption, fall in 142  
 domestic finance; depreciation of interest rates 138; financial deregulation 141; increase in savings 142; interest rates, conflicting goals 134  
 dynamic analysis 175; stability, assumption of 20; instability *see* nonlinear economic systems
- ecological economics 123–4  
 economic agents 33, 37, 39, 40, 57, 100  
 economic horizon, finite 60  
 economic power, household 94  
 economic system: comparison 105–6; foundation of 200n  
 economic history 23, 145–6; of technology 99  
 economies of scale 155–6, 166
- education, public sector initiative 166  
 efficiency 15, 61–2, 67n, 146; production 156  
 employment policies 166  
 Endangered Species Act 129  
 endogenous growth 153, 158; theory 5–6  
 endowments, redistribution 16  
 Environmental Defense Fund 126  
 environmental economics 21, 116, 117  
 environmental externalities 116  
 environmental impacts 177; on trade agreements 169  
 environmental issues 118, 120–22; political controversy 116; protection 117, 124, 127, 130  
 environmental policy, cost–benefit analysis 117; existence values 117  
 environmental values 118, 126; reviews 171, 179; survey 119; use values 123  
 equilibrium allocations 48–51, 53, 54, 64  
 equilibrium prices 17, 38; monetary 55; rates of interest 7; relative 54  
 equilibrium price vectors 74, 194  
 equivalence values 50  
 ethics 188–9  
 excess demand 68, 70, 71, 72, 73, 81, 82; function 74; matrix 60–1; vectors 52, 77  
 exchange rate 134–6, 137, 138, 141; adjustment, difficulties in 137; as key variable 136  
 existence theorem 49, 50, 54  
 existence values 118–19, 120–2, 124, 126–8, 130, 131n  
 exogenous technology 104  
 expansion: of money supply 138; trade, harmful effects 169  
 export 135, 143, 157, 160; subsidy 160  
 externalities 131n; analysis of 11  
 Exxon Valdez disaster 118–19
- factor endowment 103; differences 151; intensities 110–11; price curve 102; price distortions 110; prices 108  
 factor price equalization theorem 151  
 factor prices 7, 11  
 factors, production *see* production factors  
 factor substitution 103, 104, 105, 106  
 false positive correlations 164  
 fashions *see* preferences  
 feasible allocations, set of 39  
 feminist economic theory 30, 94, 97

fiat money 49, 60, 64 *see also*  
 commodity money; separate use  
 value

fictitious agents 83n, 85n

financial deregularization 10, 137, 141

financial liberalization 139

financial variables 112

finite horizon models 60

finite resources 123

fiscal policy 140, 143, 145

fixed-point theorem 68, 82, 83n, 108

foreign currency 137, 143

foreign direct investment (FDI) 177, 180

formalism 20

freedom of choice 182

free market: allocations of resources  
 146; capitalism 10; economic policies  
 2; global 8

free trade 8, 12, 149, 150, 157–9, 160–1,  
 163; alternatives 153, 165; compulsory  
 162, 164; critiques 155; effects 151,  
 164

Free trade agreements 169

Free Trade Area of the Americas  
 (FTAA) 169

frictions 49, 55, 56, 57, 60, 65, 66, 67n

fundamental theorems 15–16

game theory: folk theorem 4; prisoner's  
 dilemma 3; *N*-person noncooperative  
 196

General Agreement on Tariffs and  
 Trade (GATT) 135

general equilibrium theory 14, 15, 20,  
 30, 107, 149, 157, 168, 175;  
 competitive 44, 49, 64, 73, 83n

globalization 149, 163

global market: analysis 83n; interactions  
 170; perfectly competitive 155;  
 unregulated 163

global patent system 161

government intervention 2, 6, 54, 156,  
 159, 162, 198; active management  
 161; procurement 160; protections  
 161; role minimization 163, support  
 162

gross substitutability 115n

hard currencies, need for 148n

Hayek's analysis 113n

Hecksher–Ohlin theory 150–51

heterogenous elements 38; capital  
 goods 115n

Hicksian concepts 67n; methodology 55

history of technology 103

household production function model 6,  
 28; optimality 28; preferences 16, 22,  
 30

household production theory 96, 97

immigration limitation 163

impartial spectator 186–90, 192, 194,  
 196; absence of 192

import: consumer goods 139;

import-export balance 138;

income distribution 101–2, 109, 141,  
 151, 175

incommensurable values 130

increased: investment 141; returns to  
 scale 158

indirect barter *see* barter

individual agents 36, 39, 42, 44, 108, 109,  
 197

individual choice 46, 49, 55, 67n

individual possibility set 39, 46, 109,  
 184; production 41

industrialization 155, 161

infant industries 155, 166 infinite  
 horizon models 60

inflation 135, 138, 145

information 39, 44–5, 109, 157, 195;  
 requirements 18, 28

initial conditions 4, 29; parameters 65

initial endowments 50, 58, 60, 63

innovation bias 114n

input–output economic model 131n, 179

input-saving innovations 110

*Inquiry into the Nature and Causes of  
 the Wealth of Nations* 1, 13, 182–4,  
 188, 200n, 201n

insatiability 91, 92, 93, 95, 98

instability 15, 16, 87

institutionalists 8, 30

intellectual property rights 163, 180

intercapitalist competition 106, 111

interdependence 80, 84n, 95; of  
 individual preferences 88; of society  
 182–3

interdependent financial markets 136

interest rates 106, 114n, 139, 157

interlocking jurisdictions 183, 188, 190,  
 191, 196

internalization of externalities 116, 159

international: financial agencies 149;  
 financial deregulation 142; financial  
 speculation 143

International Society for Ecological  
 Economics 131n

interpersonal comparison 94; of utility  
 27, 188

intersections of sets 45

intersectoral effects on trade policies  
 172, 174, 176

inventive activity 103, 104

investment 102, 177, 180; capital 107;  
 returns 55

invisible hand 12–14, 21, 27, 111, 146,  
 181–3, 185, 189–90, 193–8

Kahn–Keynes multiplier 140

Katutani's theorem 36, 44

Kennedy–Weizsacker approach 104

Keynesian economics 88, 92

labor 108, 157, 163; free movement  
 between industries 159; market  
 policy 159; rates 106; supply and  
 demand 159; underemployment  
 156

lack of perfect knowledge 162

Lancaster's model of consumer  
 satisfaction 95

Latin America, empirical research in  
 11, 112;

Lawson approach 148n

Leontief paradox 157

Liberalization in capital markets,  
 conflicting effects 134

loan allocation schemes 142

local nonsatiety, hypothesis of 49

macroeconomics 14, 21; cyclical  
 fluctuations 29–30; microfoundations  
 for 22

mappings 68–9, 71–3, 74, 75–6, 80, 81–2;  
 artificial 78; economic meanings 82;  
 fixed point 10; mathematical  
 properties 82

marginalism 23–4, 105, 107

marginal productivity 105; theory 11

marginal products 151

market based policies 157; instrument  
 116

market: boundaries 122; bubbles 29;  
 cascades 29; clearance 132;  
 contractions 140; economy 54; forces  
 146; imperfection 57; optimality 131,  
 149, 198; process 140, 146, 181, 195,  
 196

Marshall's theory of variable returns  
 113n

Marxist political economy 30, 200n

maximization 36; consumer welfare 130;  
 output 89; profits 40, 41

mechanical system, society as 183–4;  
 analogies 24; consequences 101

Mexico, experience with an open  
 economy model 132, 134, 140, 144

microeconomic model 14, 22, 23, 26

microeconomics, macro foundations for  
 30

monetary theory 48, 55, 65, 67n

monetization of externalities 117–18,  
 130

money as a store of value 57, 60, 65;  
 integration into value theory 57–60,  
 63, 65, 66n

money, role in the economy 54–60

money, zero demand 62, 65; zero price  
 57, 64

Mundell–Fleming model 132, 134, 146

NAFTA (North American Free Trade  
 Agreement) 135, 163, 169, 177, 178

negative excess demand 46, 75, 76

neoclassical economic theory 86, 88, 90,  
 94, 95, 102–5; assumptions 87, 92

neoliberal paradigm 7

neo-Ricardian theory 100, 106

neo-Walrasian theory 66n, 107, 115n

newly industrialized economies 144

nonconvergence *see* convergence

noninstrumental role of nature 117

nonlinear dynamics 4

nonlinear economic systems 4, 5

nonmonetary equilibrium 67n;  
 competitive 56; stationary 63

nonquantitative valuation 128–9

*non-tâtonnement see tâtonnement  
 numéraire* 37, 38, 39, 58, 74, 83n

oligopoly pricing 4, 156

open economy model 11, 12; internal  
 contradictions 132, 144

open market operations 138

ordinalist revolution 27, 31n

overlapping generation models 49, 57,  
 60–3, 64

Pareto optimality 7, 15, 49, 54, 56, 118,  
 130

partial equilibrium 170, 179

- perfect capital mobility 136, 147n  
 perfect competition 8, 132, 175, 176  
 physics, analogies in economics 24–5  
 policy-oriented research 100, 108, 112–13  
 positional competition 89, 90  
 positive excess demand 74–5, 76, 77, 80  
 preference field 40, 41, 42  
 preferences, consumer 5, 26; fads and fashions 18; individual 49; revealed 27  
 price adjustment 72–4, 77, 78, 80, 108  
 private sector indebtedness 141  
 producers 99, 100, 104, 107  
 production factors 99, 101, 103, 103;  
   relative prices 100, 103, 105  
 production function 99, 101, 103, 114n  
 proof of existence of equilibrium 46, 68–9, 72–4, 80  
 pure exchange economy 31n, 49, 60
- qualitative environmental judgments 129
- rates of return 56–7  
 relative prices 101, 102, 103, 104, 106  
 research and development 104, 114n, 162  
 resources, intertemporal allocation 56;  
   substitution effect 59; substitution, marginal rate 63  
 Ricardo effect 102, 113n  
 reswitching of techniques *see* switching of techniques
- satisfaction 93, 95; of wants 92  
 scarcity 42, 89, 153  
 second best 266; theory of 8–9, 117  
 self-love, unbridled 189–90, 196  
 Sonnenschein–Mantel–Debreu (SMD) theorem 16–17, 20, 27; instability 21, 22, 30  
 stability theory 183, 195, 197  
 stationary equilibrium 61, 62, 63, 65  
 status 87, 93, 95, 98; symbols 88, 89, 91  
 sterilization 138, 139  
 substitution 106, 107, 140  
 supply and demand 10, 37, 108;  
   individual 43; law of 68–70, 72–3, 75–6, 77–9, 81–2  
 switching techniques 105; reswitching 106, 114n
- tâtonnement* 17; non-*tâtonnement* models 115n, 195; price formation 195; processes 58, 115n  
 tariff rate 161; optimal 154, 155; reductions 154, 177  
 tariffs 154, 160, 161; dismantled 177; to protect employment 159; protection 162; targeted 156  
 tax revenues 145  
 technological change 100, 101, 102–4;  
 terms of trade 154, 155, 156  
*Theory of Moral Sentiments* 181–3, 185–9, 190–1, 193, 198–9, 200, 201n  
 trade agreements 153, 158, 169, 171, 180; secondary effects 170; tertiary effects 170  
 trade impacts: on the environment 154, 159; on labor 154, 158, 159  
 trade liberalization 132, 137, 179; effects 170; negotiations 169
- unemployment 158–9, 175, 178  
 unit of account, *see* *numéraire*  
 use values 116, 117, 119, 125, 126, 128, 130  
 utility function 26, 31n, 60, 63, 83n, 84n
- valuation of environmental impacts 116, 120, 122, 123, 128; surrogate prices 129  
 value added tax 145  
 value theory 48, 65  
 Veblen effect 88, 90
- Walrasian general equilibrium 17, 58, 72, 75, 79; monetary theory 67n  
 wants, hierarchy of 91, 92; human 93  
 willingness to pay 127–8, 130  
 World Bank 111, 163, 176, 177  
 world trade negotiations 169  
 World Trade Organization (WTO) 163, 169; rules 161