The Walrasian Model's Assumptions

The following assumptions are implicit rather than explicit in the Walrasian model we've developed:

(1) Each individual unit (each household or firm) is a ***price-taker*** — *i.e.*, each one behaves as if its own actions will not affect prices. We might expect this to hold, for example, if there are many buyers and sellers in each market. How many? Some empirical evidence suggests that the number doesn't have to be very large, perhaps as few as five or ten on each side of the market in many cases. Note, though, that this will also depend on what is "the market." Strictly speaking, each market would have to be for a single, homogeneous good — a market in which consumers are indifferent between goods sold by any two sellers.

(2) There are ***complete markets*** (a market and a price for each commodity) and ***complete and accurate information*** about each market (each participant knows the price and the characteristics — *e.g.*, the quality — of each good).

(3) There are ***no externalities***.

When we use an economic model to obtain understanding, explanation, or prediction, we don't expect the model to provide any of these perfectly. But we expect the model to give us better explanations or predictions if the above assumptions are approximately satisfied when we apply the model. While we don't expect the actual economy to be precisely in equilibrium, we expect the model's equilibrium to be "near" the economy's actual state. Therefore there's an additional assumption that's important:

(4) The underlying data (preferences, technology, *etc.*) are not changing too rapidly, so that stability issues are not very important and we can expect to actually be "near" an equilibrium.

The remainder of the course will consist almost entirely of discarding one after another of the first three assumptions: first developing the model when participants aren't price-takers; then when there are incomplete markets (in particular, incomplete markets for dealing with uncertainty and time); and then when there are externalities. We begin by studying the ***core***, a notion of bargaining equilibrium in which the participants don't take prices as given. We'll also make brief mention of the fourth assumption as well.