

## Money and generalized exchange: A critical look at Neo-Walrasian theory

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### Abstract

The proof of existence of market clearing equilibrium is the cornerstone of Neo-Classical theory. While it is generally portrayed as a barter framework, the proof actually assumes an accepted system of credits and debits; a system of privately issued IOU's, or what is the same thing commitments by private agents to deliver a certain quantity of a given commodity at a given equilibrium price. In other words, the proof presupposes the existence of 'inside money'. Yet a system of generalized exchange with pure inside money is not compatible with the main principles of Neo-Classical monetary theory including that inflation is always and everywhere a monetary phenomenon, the exogeneity of money and also the neutrality of money. This explains the importance and necessity of introducing 'outside money' in general equilibrium. Focussing mainly on Patinkin's 'invalid dichotomy' and the real balance effect, and to a lesser extent, on overlapping generation models, I try to show that these attempts have been unsuccessful. In both cases the integration of monetary and value theory amount to collapsing all individuals into a single one. This negates the very economic problem (*i.e.*, multiple exchanges) that gave rise to general equilibrium theory and to the impending requirement to prove the existence of market clearing equilibrium.

**Key words:** existence, general equilibrium theory, Neo-Walrasian monetary theory, inside and outside money, overlapping generations model.

**JEL Classification:** D50, E13, E52, E31.

### Resumen

La prueba de existencia del equilibrio general es la piedra angular de la teoría neoclásica. Si bien se presenta, generalmente, como un marco basado en el trueque, la prueba de existencia del equilibrio general asume de hecho un sistema aceptado de créditos y débitos; un sistema de promesas de pago emitidas por los privados o, lo que es lo mismo, compromisos por parte de los agentes privados de entregar una cierta cantidad de un

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Manuscript received on July 1<sup>st</sup>, 2015; accepted on September 11<sup>th</sup>, 2015.

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determinado bien a un precio de equilibrio dado. En otras palabras, la prueba de existencia del equilibrio general presupone la existencia de ‘dinero interno’. No obstante, un sistema de intercambio generalizado no es compatible con los principios de base de la teoría monetaria neoclásica, incluyendo el hecho de que la inflación es siempre, y en todas partes, un fenómeno monetario, el dinero exógeno, y también la neutralidad del dinero. Esto explica la importancia y necesidad de introducir ‘el dinero externo’ en el marco del equilibrio general. Centrándonos en la ‘dicotomía inválida’ de Patinkin y el efecto de los saldos reales, y en menor medida en los modelos de generaciones traslapadas, tratamos de demostrar que los esfuerzos de integrar el dinero externo en un marco de equilibrio general han sido infructuosos. En ambos casos, la integración de la teoría monetaria y de la teoría del valor equivale a colapsar todos los agentes en uno solo. Esto es lo que niega el propio problema económico (*i.e.*, el problema de intercambio múltiple) que dio lugar a la teoría del equilibrio general y al requisito imperante de probar su existencia.

**Palabras clave:** existencia, teoría general del equilibrio, teoría monetaria newalrasiana, dinero interno y dinero externo, modelo de generaciones traslapadas.

## INTRODUCTION

The proof of the market clearing equilibrium is the cornerstone of mainstream (Neo-Classical) Neo-Walrasian economic theory.<sup>1</sup> All models are explicitly or implicitly based upon it. The proof of existence and the assumptions on which it is based have not been exempt from criticism. One of the most important is that the proof of existence does not need the existence of money.

In a Neo-Walrasian world even of the temporary equilibrium variety transactions are planned for by the *deus-ex-machina*.<sup>2</sup> Prices are determined and trans-

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1 In what follows Neo-Classical theory is discussed within its Neo-Walrasian version. The main characteristics of the Neo-Walrasian approach include among others, that goods (commodities) are distinguished and specified by their physical attributes, spatial location, and time of delivery. All goods have a market and a price. Agents are price takers and are divided into two categories into producers (firms) and consumers. Consumers are defined by a consumption set, a utility function and an endowment of goods. Both agents have production and consumption plans that are complete. That is, both decide in time  $t$ , at the beginning of a given period, the types and amounts of goods to consume and produce through the rest of their useful lives. The specification of preferences (utility functions), technology, size of endowments and distribution of endowments constitute the required data “to establish the model of price formation as the outcome of the competitive resolution of individual utility maximization subject to the constraints of technology and endowments” (Eatwell, 1982). The focus of this paper is on exchange (consumers) and the issues arising from the inclusion of non-reproducible factors and reproducible means of production are not addressed.

2 Or in the words of Intrilligator the anthropomorphic representation of the market, *i.e.*, the auctioneer. See Intrilligator (1971).

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