

# Modern market equilibrium based on flawed models

[Economics](#)



In this neo-liberal world, everything is linked to theories that systematize consumer behaviours and assume that everyone is acting on rational basis. As it was demonstrated by many great economists and behavioural thinkers, it is not the case. How is it that we still function in an economy that is based on flawed models? Should they be revised? How? A great example of this lack of understanding is the market equilibrium that should represent a perfect situation but occurs rarely in reality.

### **So the question is; what is market equilibrium?**

We need to go back to the twentieth century, after a great period of Keynesianism, a new generation of economists decided to explore abstract equations and operations in economics. The basic idea was that the economy lens towards a situation of equilibrium and that only unpredictable shock from outside of the system can disturb this stable situation. As they develop their theory, they invent rigorous mathematical formalism to which compare imperfect reality to. In fact, economic equilibrium is a state in which economic variables are perfectly balanced and remain consistent as no external influences disturb it. This is a state of optimum balance between supply and demand. The perfect price situation happens when the price for a product reaches a point at which the demand for product at that price equals the level of production. This can also be applied to other variables such as the interest rates that will allow the greatest growth of any sector. This state of equilibrium, as stated in the theory, is an optimum outcome for society. It is reached as individual greed leads the market to this position, to a collective result.

## **What is the issue with this particular model?**

The problem is that this supposedly balanced state of economic equilibrium can be disrupted by exogenous or external factors; it could for example be a change in consumer preferences. This can lead to a significant decline in demand and as a result, an oversupply condition in the market. When this happens, a temporary state of market disequilibrium will predominate until a new equilibrium is found. In this model, these changes appear to be external to the economy and a great disruption when in fact it is part of the natural circle of the market as consumers preferences will always change and this situation is not an imperfect one.

The state of equilibrium can also be disrupted by any large-scale events. It could be economic shifts related to events, such as the 2008 financial crisis which led to immense imbalances in the American housing market, or changes in response to large-scale natural disasters. For example, if a factory is destroyed in a flood, the remaining supply may not be sufficient to meet long-term demand. Likewise, consumers who are managing losses due to a fire that destroyed their houses may choose to change their spending habits based on new priorities, such as the replacement of the house. In cases where a disaster results in temporary unemployment, consumer spending for non-essentials items may decrease or end, resulting in a supply surplus.

Reliance on flawed models like this one contributed to the extent of the 2008 crash. Indeed, it encourages decision-makers to underestimate risks, economic theory has the power to make the world more dangerous. As a

result, bankers will be more inclined to take risks because they know that central banks or the IMF will fly to their rescue to prevent a global crisis.

More than \$10 trillion were provided to financial institutions, banks and shadow banks, and big corporations, and foreign banks by US policy makers in the government and at the US central bank, the Federal Reserve to avoid global depression, but the peril remains real. Stagnation is still a real threat that encourages central bankers, governments to loosen their monetary policy. But according to orthodox economic theorists it would have no real effect if the central banks did all of this. Because their equations show them that there is no correlation between monetary policy and output. Mario Draghi could double interest rates and slash quantitative easing and the economy should grow at just the same rate, says the theory.

There might be a failure in a discipline that becomes over-reliant on maths. There are, as result, big implications for the way governments and central banks make policy. Instead of abstract models, you would need something much closer to reality. It would be more appropriate to not rely so much on maths and flawed models that do not depict reality accurately and shift the perspective of trying to make the imperfect world fit into a “ perfect” model and understand that the world cannot be explained by these kinds of models. It is important to try and invent something less abstract that doesn't involve a perfect situation. It might be better to have a broader vision, see the world as an aggregation of agents and not a model with a limited number of variables.