

CONSUMER'S EQUILIBRIUM UNDER ORDINAL UTILITY THEORY

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WHAT IS CONSUMER'S EQUILIBRIUM ?

- A consumer is in equilibrium when given his tastes and prices of the two goods, he spends a given money income on the purchase of two goods in such a way as to get the maximum satisfaction
- Indifference Curve- Consumer's equilibrium is discussed in respect of the purchases of two goods

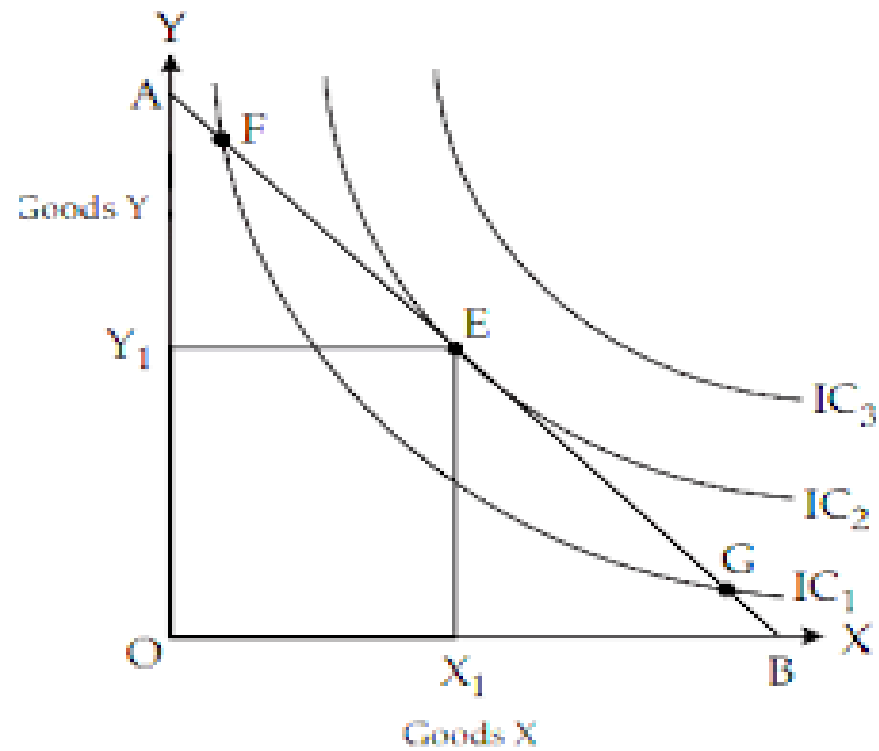
ASSUMPTIONS

- The consumer has a given indifference map exhibiting his scale of preferences for various combinations of two goods, X and Y
- Consumer has a fixed amount of money to spend on two goods and he has to spend whole of his given money on the two goods
- Prices of the goods are given and constant for him
- Goods are homogeneous and divisible

CONSUMER'S EQUILIBRIUM

- Which combinations of two goods, X and Y, the consumer will decide to buy and will be in equilibrium position- consumer's indifference map and price line need to be brought together
- Consumer's preferences are given in indifference map
- The budget line of the consumer is AB
- Good X is measured in X axis and good Y is measured in Y axis

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- The consumer will choose that combination on the price line AB which lies on the highest possible indifference curve
- The highest possible indifference curve is second indifference curve in the example
- The tangency point E is the equilibrium point

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- At the tangency point E, the slopes of the price line AB and indifference curve IC-2 are equal
- Slope of the indifference curve shows the MRS of X for Y
- Slope of the price line indicates the ratio between the price of two goods

CONSUMER'S EQUILIBRIUM

- At the equilibrium point E
 - $MRS_{xy} = \frac{MU_x}{MU_y} = \frac{P_x}{P_y}$ (First Condition)
- This is necessary but not sufficient condition
- Second condition-Indifference curves must be convex to the origin/ MRS_{xy} must be falling at the point of equilibrium