3.2 PARTIAL VERSUS GENERAL EQUILIBRIUM ANALYSIS

In partial equilibrium analysis, we concentrate on a single market, in isolation from the rest of the economy. We analyse in detail a particular market or a set of markets neglecting everything else. For instance, when we want to study the market for wheat in detail, we do not bother about other markets in the economy. Such an analysis is based on c*eteris paribus* assumption. Demand and supply models of price determination of a good is based on partial equilibrium analysis. It ignores various linkages and inter-relationships that might exist between different markets. On the other hand, in general equilibrium analysis we analyse simultaneously all the markets in the economy. The basic premise in such an analysis is that, "everything depends on everything else". *All the markets of the economy are interdependent and interrelated so that a disturbance originating from any one market will have repercussions throughout the economy*. In such a situation general equilibrium analysis is the correct approach for analysing the functioning of the economy. In fact, partial and general equilibrium analyses are two ways of looking at the functioning of the economy.

Partial equilibrium analysis is appropriate when we want to analyse in detail the functioning of a particular market or a particular sector of the economy. It is used when a market is self-contained or insulated from other markets or when the market in question is relatively small, relative to the size of the economy, or when the cross-effects generated by this particular market are negligible and hence can be ignored. Partial equilibrium analysis makes the analysis of a problem more manageable, unlike general equilibrium analysis which is often difficult to comprehend. Reality is so complex that one needs a process of simplification (abstraction) to understand it. Partial approach is one such form of simplification, where each market is viewed in isolation. Partial equilibrium analysis was championed by Alfred Marshall (1890) and is based on "*ceteris paribus*" assumption. Such an assumption abstracts from all interconnections and inter-links that exist between the market under study and the rest of the economy. For instance, we use demand-supply model to show how equilibrium price and quantity is determined in each market, independently of other markets. However, we know very well that a change originating from any market has spillover (repercussions) effects on other markets. When these changes in other markets (sectors or industries) are significant, the partial equilibrium analysis is inappropriate and inadequate. By taking into account only the direct effect on price and quantity, partial equilibrium approach, "provides a misleading measure of the total, final effect, after all the repercussions or feedback effects from the original change have occurred." If and only if the market or the sector (industry) from which the original change occurs is relatively small and has very few linkages with the rest of the economy, the partial equilibrium analysis would be the right approach to study the operation of market system . Otherwise a general equilibrium approach is needed.

When market (economic) interdependencies or interrelationships are not taken into account, or do not exist, partial equilibrium analysis is the correct approach. However, when such interrelationships and interdependencies exist and are important, and the ignorance of which will have serious consequences or will prove costly in terms of the quality of economic predictions, a general equilibrium analysis must be used. It must be used whenever an event has all pervading effect.

Check Your Progress 1

1) If you want to study in details the working of the market for milk in your city, which methodology will you use?

2) As demand for automobiles goes up, the demand for steel goes up, which in turn