DRAFT – “Defects in Market Equilibrium Pricing”

Bharat; bharat0economics@gmail.com

Abstract: how do we price anything? – we use market equilibrium. If there is defect in equilibrium? – market will correct itself. If the defect remains undetected for too long? - will the market correct with a crash! Timely health checks may help.

--Main Body--

How do we decide the price of anything - if it is very high or very low. We generally look at what people say or what it was priced in the past. Experts generally use some complex calculations such as how much it costs to make or how much benefit we get.

If someone says a currency is(priced) very high, how do we know what its correct price is?

Is there someone who can calculate the correct price of currency?

The government which creates it? … they may calculate their price but market generally changes it.

People who buy or sell it? … every person has their own calculations.

Market experts? … they may give some argument for everything.

Wise people say that if the currency is traded in a market where millions of people buy and sell it every day - its true price gets valued automatically. Say if it is high, people start selling which reduces the price until it becomes reasonable. We can call this **Market Equilibrium Pricing**.

Market Equilibrium does have defects

Could it be possible that the entire market is pricing a currency very improperly. For example, if a country printed fresh currency, the price did not fall but remained stable!

Why the increase in supply does not reduce the price. If there is demand, why the price does not rise further! Where is it going wrong.

Is the market reflecting true equilibrium and how will you calculate prices in such a market?

Does it create a **defective equilibrium** - where calculations do not match.

Does the market remain in equilibrium every day or how do we know when it is not?

Can we say that the market has a defective equilibrium today! It is difficult to prove defective equilibrium because different people use different calculations. People generally use vague personal sense, based on their experience, to say price looks wrong, high or low.

Almost everyone, including governments, trust the market equilibrium on any day as the indicator of true price; until they develop a sense of something wrong.

Also, most of the consumers do not verify the market price with their own calculations every time. It is painfully difficult to find all information on demand and supply and then calculate the true price. They simply wait for the market to correct automatically.

Should we ignore the defects for too long

If there is a defect in market equilibrium - how will you tell if the prices are high, very high or just normal? Should governments/market experts wait too long for the market to correct itself? Shouldn't they start looking into the market for defects occasionally.

If market does not realize defects for too long it may continue using defective equilibrium as normal because they cannot prove something is wrong. This phenomenon may explain why market crashes happen all of a sudden but take several years to build up; and surprisingly no one realizes they have been building for very long.

There may be other indicators to crosscheck if defects existed in this currency market – when fresh currency was issued inflation may have risen, but did it? Is it just sticky hidden demand or a defect that we may have started holding currencies as long-term investment and do not realize it as investment at all! Are one or two currencies too convenient to hold that people may simply ignore occasional release of new print. Is it possible that the defects in currency equilibrium may have increased the impact of the 2008 Financial Crisis to several countries and other markets such as stocks or property.

We may take **one more example** to test defect in equilibrium pricing – **interest rates**.

Banks borrow and lend money to customers for interest, why would they do the same at a lower rate when they have to borrow from each other! … because the lender has more funds to lend but less customers to borrow so they lend it to another bank at a lower rate.

Should the lending rate to another bank be very low compared to the lending rate to any customer? If the interbank rate is low - why would the borrower banks not borrow from another bank but the deposit customers!

Does the market-traded interbank rate reflect true market equilibrium? Is it possible that the supply of money is so high that any demand cannot move the rate upwards – surprisingly it does not boost the inflation similarly! Importantly, if the experts, banks or governments, are not capable of detecting it; who would be?

Conclusion

The above discussion shows that defects exist in market equilibrium pricing and may remain undetected/unproven for years. This hypothesis of Defects in Market Equilibrium Pricing applies to almost all markets using equilibrium pricing. Several other markets can be tested for defects similarly.

---Ends--