

# The Invisible Hand

Markets II: Prices, Incentives, and Trade  
PPE 101

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Questions?

## Review: Hayek on Prices

## Hayek's Insight



- Prices convey **information** (about the supply and demand for the good/service)
- No single person possess all or most of this information; knowledge is **dispersed**
- Prices help **coordinate** the actions of many people

## Price (as a signal)

How does it work?



**Prices** communicate *information* about which goods/services to produce and about how to allocate them, while also providing *motivation* for people to make best use of this information.

Price is a signal wrapped up in an incentive

## Price (as a signal)

How does it work?

**Prices** communicate information about goods/services to produce and allocate resources while also providing *motivation* for the use of this information.



Price is a signal wrapped up in an incentive



in goods/services while also use of this

## Regulating prices?

Hayek would disapprove



- Markets efficiently aggregate the knowledge possessed by individuals dispersed throughout society
- Government cannot “know” what the market does
- When government interferes, it distorts the information conveyed by prices, leading to inefficiencies

## Price (as a signal)

**Prices** convey **information** about the **scarcity** of goods and services, which **motivates** people to produce, consume, invest, and innovate in ways that make the best use of an economy’s productive potential.

This allows the **market** to **coordinate** the **division of labor** through the **exchange** of goods and services among a dispersed and varied population **without centralized direction**.



# The Invisible Hand

## The 'Magic' of the Market

**Hayek:** Think of the market as a giant information-processing machine  
It produces prices, which helps coordinate behavior toward (typically) desirable ends.

But it is a machine with *no maker*.

It was not *designed* and no one *controls* it.

How does it work?



## The 'Magic' of the Market

**Smith:** Social effects can arise *spontaneously* from individuals pursuing their own interests (without anyone intending those effects).

In particular, Smith thought that sometimes *positive* social effects can result from individuals acting in their own self-interest.



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It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our necessities but of their advantages (WN I.2.12).



## The 'Magic' of the Market

### WARNING:

Smith *does not* think that all people are inherently greedy or selfish.

Market = machine that converts *self-interest* into *mutual gain*.

(But how?)

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## Invisible Hand Explanations

### Invisible Hand Explanation:

- (1) A certain pattern of human activity arises from the intentional actions of some individuals,
- (2) No one acted with the intention of bringing about that pattern.

Every individual... neither intends to promote the public interest, nor knows how much he is promoting it... he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention (WN IV.2.9).



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### Under certain conditions, *markets produce positive social effects.*

### But not always.

And spontaneous orders needn't always be positive.



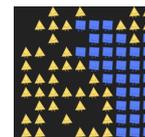
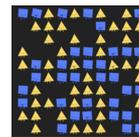
## Segregation Model

### Invisible Hand Explanation:

- (1) A certain pattern of human activity arises from the intentional actions of some individuals,
- (2) No one acted with the intention of bringing about that pattern.

### Example:

Thomas Schelling's Segregation Model



## Segregation Model

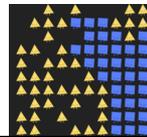
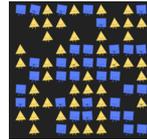


Thomas Schelling's Segregation Model (<https://ncase.me/polygons/>)

Individuals have a preference to not be a minority in their neighborhood.

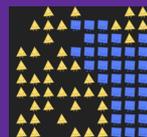
In aggregate, as a result of individuals acting on their preferences, segregation emerges.

... even if everyone prefers integration over segregation.



Discussion  
Question:  
What can be  
done?

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Questions?