The Market

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BECO 5376 - Austrian Economics

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Types of human action

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Hegemonic

A relationship one of command and obedience, with commands being enforced by threats of violence

Noninvasive action - Voluntary exchange

Exchange occurs when each party have different proportion of assets of goods in relation to his wants. This leads to specialization and the *division of labor*.

1. Differences in suitability and yield of nature-given factors
2. Differences in given capital and durable consumers' goods
3. Differences in skill and in the desirability of different types of labor

On the Principles of Political Economy and Taxation (1917) - David Ricardo

Leads to the law of association, law of comparative costs, or the law of comparative advantage

Social cooperation

Man, Economy, and State (1961) - Rothbard, p. 100

"Individuals recognize, through the use of reason, the advantages of exchange resulting from the higher productivity of the division of labor, and they proceed to follow this advantageous course. In fact, it is far more likely that feelings of friendship and communion are the effects of a regime of (contractual) social co-operation rather than the cause."

Social cooperation

The Wealth of Nations (1776) - Adam Smith, Book 1, Ch II

"Whether this propensity be one of those original principles in human nature of which no further account can be given; or whether, as seems more probable, it be the necessary consequence of the faculties of reason and speech, it belongs not to our present subject to inquire."

Social cooperation

Principles of Economics (1871) - Carl Menger, p. 176-177

"The propensity of men to trade must accordingly have some other reason than enjoyment of trading as such. If trading were a pleasure in itself, hence an end in itself, and not frequently a laborious activity associated with danger and economic sacrifice, there would be no reason why men should not engage in trade in the cases just considered and in thousands of others. There would, in fact, be no reason why they should not trade back and forth an unlimited number of times. But everywhere in practical life, we can observe that economizing men carefully consider every exchange in advance, and that a limit is finally reached beyond which two individuals will not continue to trade at any given time."

Terms of exchange

- Inequality of values by the participants between the goods being traded
- Object of all action is to *maximize psychic value*
- Psychic costs include all that the actor gives up by making the exchange (opportunity costs)
  - This is equal to the next best use

Market roles

1. Consumers: enters the market to purchase goods and services for consumption. There are numerous opportunities to buy different kinds and quantities of goods and services. The consumer must choose between the alternatives available.
2. Resource owners: Owners of raw materials, labor services to sell, and other productive resources.
3. Entrepreneurs: Makes the ultimate production decisions. He decides what resources should be used and/or what goods and services should be produced. Making decision under uncertainty is the essence of being an entrepreneur.

Any one person can fulfill more than one of these market roles. All resource owners and entrepreneurs are also consumers.

Equilibrium price (mainstream economics)

Assumptions in a perfectly competitive market - Nicholson & Snyder Ch. 12, Sec. 4

1. Large number of firms, each producing the same homogeneous product
2. Each firm maximize profits
3. Firms and consumers are price takers
4. Perfect information - prices are assumed to be known by all market participants
5. Zero transaction costs

Equilibrium price

The price where quantity demanded is equal to the quantity supplied *and* neither demanders nor supplies have an incentive to alter their economic decisions

$$D(P^*) = S(P^*)$$

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Equilibrium price (Austrian economics) - Eugen von Böhm-Bawerk's "marginal pairs"

Buyers

Smith

101
(A horse)
100

Brown

91
(A horse)
90

Johnson

81
(A horse)
80

Sellers

Miller

106
(A horse)
105

Davis

96
(A horse)
95

Thomas

86
(A horse)
85

Marginal pairs - cont'd

Buyers

Smith
- 101
- (A horse)
- 100 ←

Brown
- 91
- (A horse)
- 90 ←

Johnson
- 81
- (A horse)
- 80 ←

Sellers

Miller
- 106 ←
- (A horse)
- 105

Davis
- 96 ←
- (A horse)
- 95

Thomas
- 86 ←
- (A horse)
- 85

Equilibrium price

Sellers of horses	Minimum selling price
Miller	106
Davis	96
Thomas	86

Buyers of horses	Maximum buying price
Smith	100
Brown	90
Johnson	80

	Horses	
Prices	Supplied	Demanded
$80 \leq$	0	3
81-85	0	2
86-90	1	2
91-95	1	1
96-100	2	1
101-105	2	0
$106 \geq$	3	0

Limits of prices

Upper marginal pair - upper limit of price

1. The last buyer (marginal buyer) - the least capable of the successful buyers. If prices rise, this buyer would be the first to drop out. (Smith)
2. The excluded seller - most capable of the unsuccessful sellers. If prices rise, this seller would be the first seller to successfully sell. (Davis)

Lower marginal pair - lower limit of price

1. The last seller (marginal seller) - the least capable of the successful sellers. If prices drop, this seller would be the first seller to to drop out. (Thomas)
2. The first excluded buyer - the most capable of unsuccessful buyers. If prices drop, this buyer would be the first buyer to successfully buy. (Brown)

Many buyers and many sellers

- From the previous example and the analysis Rothbard gives on one seller to many buyers, we can extend our analysis to n number of buyers and n number of sellers
- Buyers will tend to start negotiations with the lowest prices possible
- Sellers will tend to start negotiations with the highest prices they believe they can obtain

Assuming the price where no sellers want to sell

- Upbidding by buyers occurs. As the offering price rises
  - The least capable buyers begin to be excluded from the market
  - The disproportion between the amount offered for sale and the amount demanded for purchase at the given price diminishes
  - So long as the amount demanded for purchase is greater, the mutual overbidding of buyers will continue to raise the price
  - When the price is so high that the supply exceeds the demand at that price, the underbidding of suppliers will drive the price downward
- As the offering price falls
  - More sellers are excluded from the market
  - More buyers enter the market
- The market is cleared when there is no incentive for buyers to bid prices up further or for sellers to bid prices down

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Differences between mainstream and Austrian assumptions

Mainstream assumptions

1. Large number of firms, each producing the same homogeneous product
2. Each firm maximize profits
3. Firms and consumers are price takers
4. Perfect information - prices are assumed to be known by all market participants
5. Zero transaction costs

Austrian comparison

- (1) Homogeneous product dependent on the subjective evaluation of the actors, not the physical property
- (2) Maximize psychic value, not necessarily monetary profit
- (3-5) Not assumed

Austrian emphasis

- Uncertainty
- Equilibrium as a process; disequilibrium; ceaseless agitation
- Imperfect information
- Entrepreneurship

Many buyers and many sellers (revisited)

In real-life markets, with many buyers and many sellers, the upper and lower price limits will be extremely close together, often resulting in a single possible market-clearing price—the law of one price.

Human Action (1949) - Ludwig von Mises, Ch. 16, Sec. 1

"[Prices] are determined between extremely narrow margins: the valuations on the one hand of the marginal buyer and those of the marginal offerer who abstains from selling, and the valuations on the other hand of the marginal seller and those of the marginal potential buyer who abstains from buying."

Economics and Knowledge - F.A. Hayek

- Question: In a world where knowledge is dispersed among many different agents and the information in which any one agent holds is not necessarily correct, how can social coordination ever take place, or, in other words, how can an equilibrium state arise?
  - Is equilibrium analysis just merely transformations of the initial assumptions?
- Criticism:
  1. Economic theory has not been developed in a formal enough manner to complete the isolation of this branch of logic
  2. The tautological propositions of pure equilibrium analysis are not directly applicable to the explanation of social relations
- Goals:
  1. Help develop economic theory more formally so that it can be used as a tool like mathematics
  2. Explain equilibrium and social coordination

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Hayek on the development of equilibrium theory

- "The assumption of a perfect market in this sense is another way of saying that equilibrium exists, just but does not get us any nearer an explanation of when and how such a state will come about" (p. 45)
- The inclusion of the "perfect knowledge" condition (Kaldor, 1934)
  - Interpreted in the absolute sense - nothing will happen in the world
  - We want to include changes which occur periodically

Hayek's answer

The Use of Knowledge in Society (1945) - F.A. Hayek, p. 528

"The price system is just one of those formations which man has learned to use (though he is still very far from having learned to make the best use of it) after he had stumbled upon it without understanding it. Through it not only a division of labor but also a coordinated utilization of resources based on an equally divided knowledge has become possible."

Speculation

1. Use-value: possession of goods that *directly* provides satisfaction of needs
2. Exchange-value: possession of goods that *indirectly* provides satisfaction of needs

- If buyers foresee that the final equilibrium price will be lower than the current price, they will wait for the price to fall
- If the current price is below the equilibrium price, buyers will tend to buy some of the good to resell at a profit at the final price
    - Exchange-value enters the picture
- The more this anticipatory, or speculative, element enters into supply and demand, the more quickly will market price tend toward equilibrium

Market operation

Conditions under which the market operates (Kirzner)

- Each member is free to act, within very wide limits, as they see fit
- Framework of law which recognizes individual rights to private property
- Each member at any one time have likes, dislikes, and preferences
- Members of the system are not assumed to have perfect information or theoretical knowledge on market operations

The structure of markets

- Order of a good
  - Lowest order good: direct consumption good
  - Second order good: goods required for the production of the lowest order good
  - Third order good: goods required for the production of the second order good
  - And so on
- Vertical relationship: when goods or services bought in one market are sold in another market
- Horizontal relationship: when two different markets compete to either buy from a higher order market or sell at a lower order market

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Types of exchangeable goods

- Alienable goods
  - Consumers' goods
  - Producers' goods
  - Tangible commodities - such as horses, fish, eggs, etc.
  - Intangible services - such as insurance, repairs, consulting, etc.
  - Claims: secure evidence of ownership of the good
    - Titles: evidence of ownership
    - Shares: evidence of part-ownership
    - Credit: evidence of ownership on a future good
- Inalienable goods
  - Personal will

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Appropriation of property

Labor theory of property (Lockean and Rothbardian)

- Legitimate claim on property: an individual mixing his or her labor with any piece of nature that has never been used
- The case of animals: Rothbard argues that animals is "economic land" (domestication results in a title claim)
- Production does not create matter. Production uses and transforms and rearranges them for the desired goods to satisfy ends

Differences between Locke and Rothbard

- Ownership into perpetuity
- Lockean proviso

Enforcement against invasion of property

Contracts and enforcement

- Enforcement: against *invasive action* - any action—violence, theft, or fraud—taking away another's personal freedom or property without his consent
- Contracts: agreed-upon exchange between two persons of two goods, present or future
- Legitimate actions:
  - Blacklist or boycott
  - Blackmail