3.4 — The *Dynamic* Benefits of Markets

ECON 306 • Microeconomic Analysis • Fall 2022

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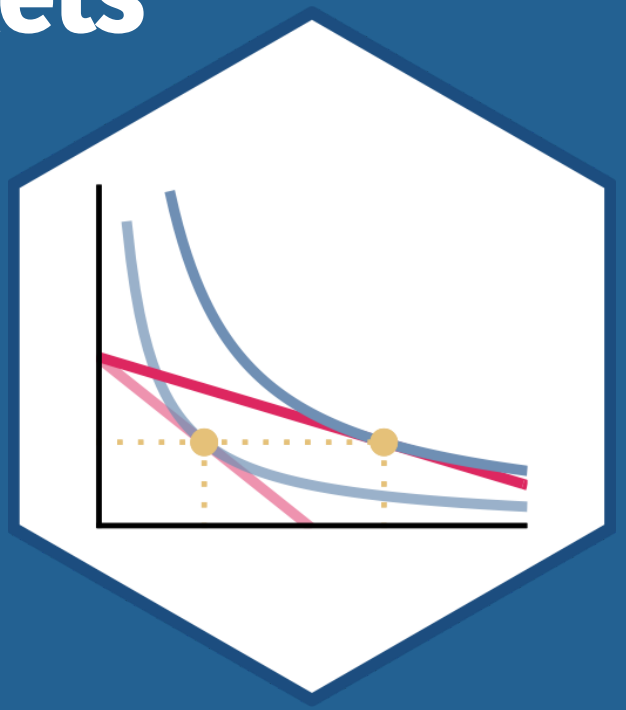
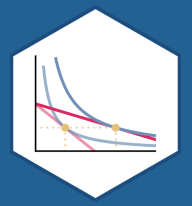


Outline

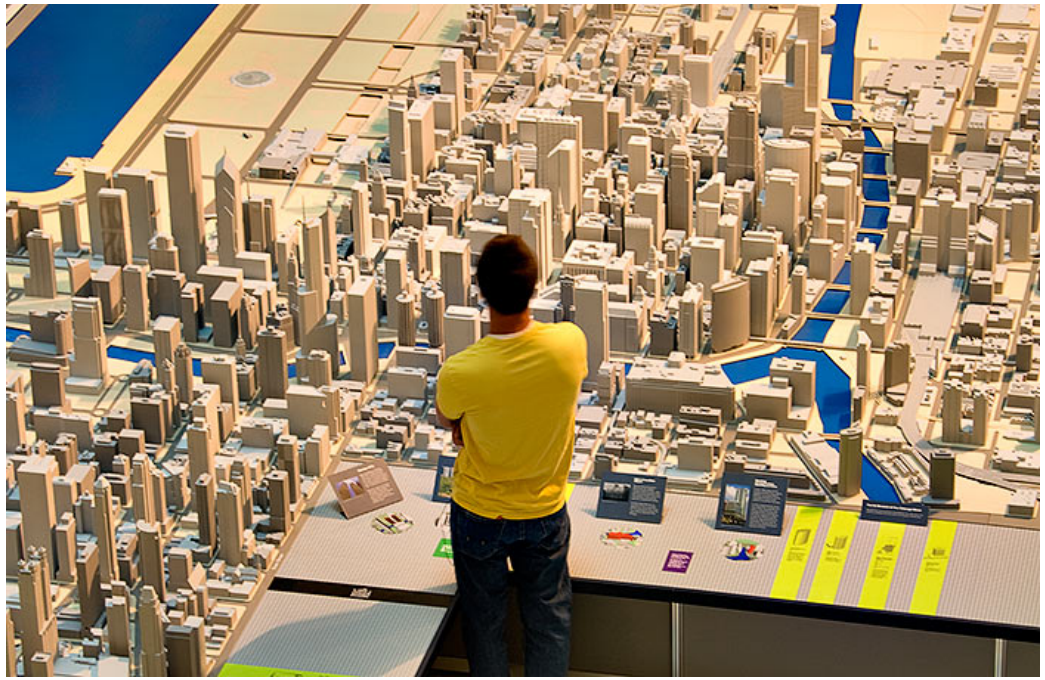


Why Markets Tend to Equilibrate, Redux

The Social Functions of Market Prices

Uncertainty and Profits

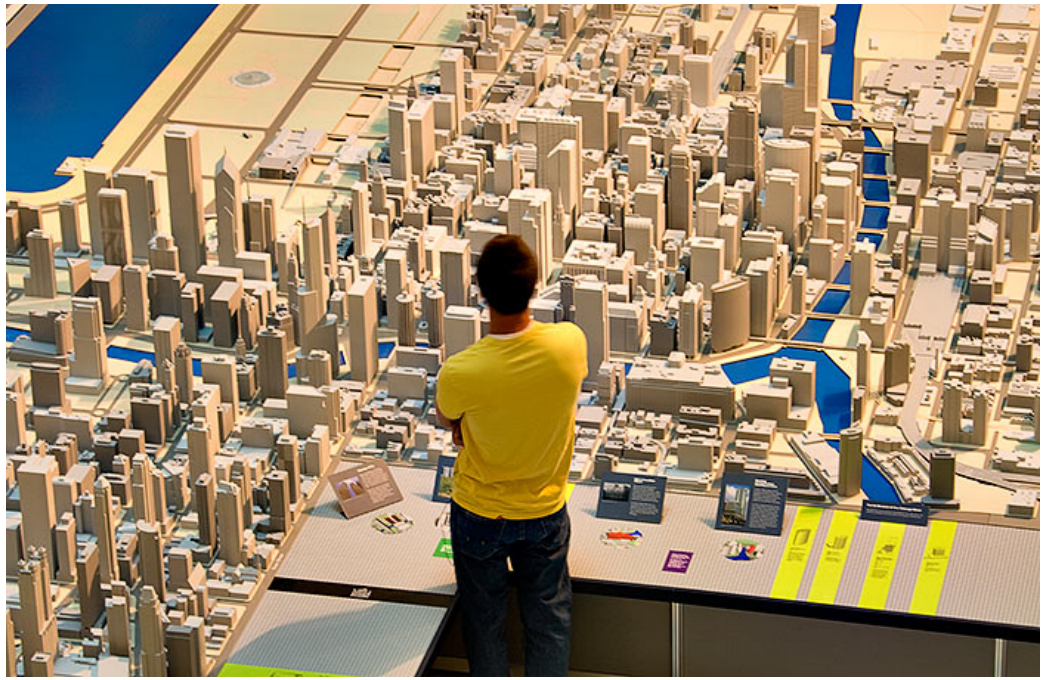
The Model is Not the Reality I



> *"All models are wrong, but some are useful."*

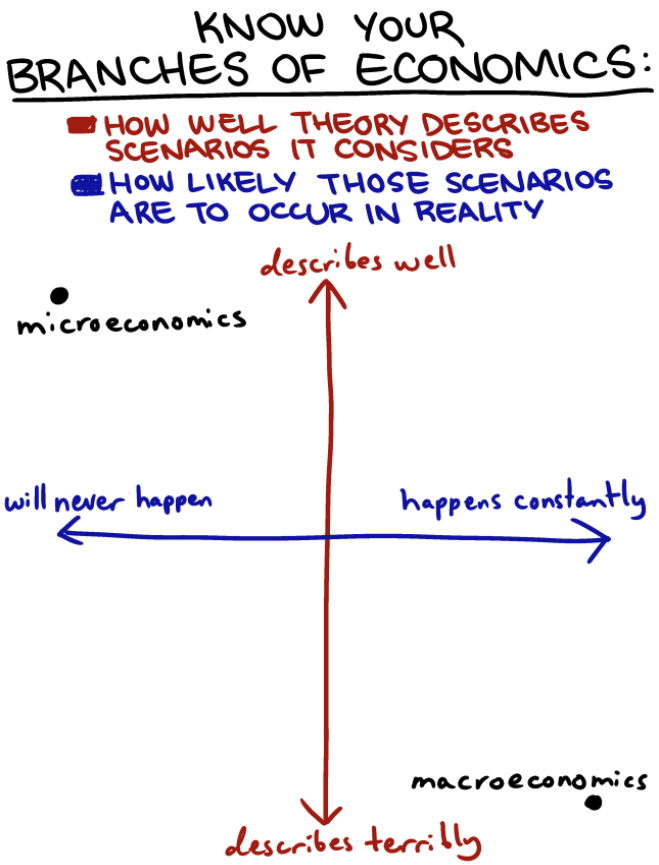
- This course is about economic modeling and formal theory
- Lots of applications beyond this course
- Models help us *understand* reality, but they *are not* reality!
    - Don't mistake the map for the territory itself

The Model is Not the Reality II



- Our models so far have given us interesting results:
  - Markets reach equilibrium
  - Economic profits are zero in the long run in competitive markets
- Both are **fictional**!
- But the models **still** show us useful insights about how a market economy works
- Some readings in today's readings page to help you understand

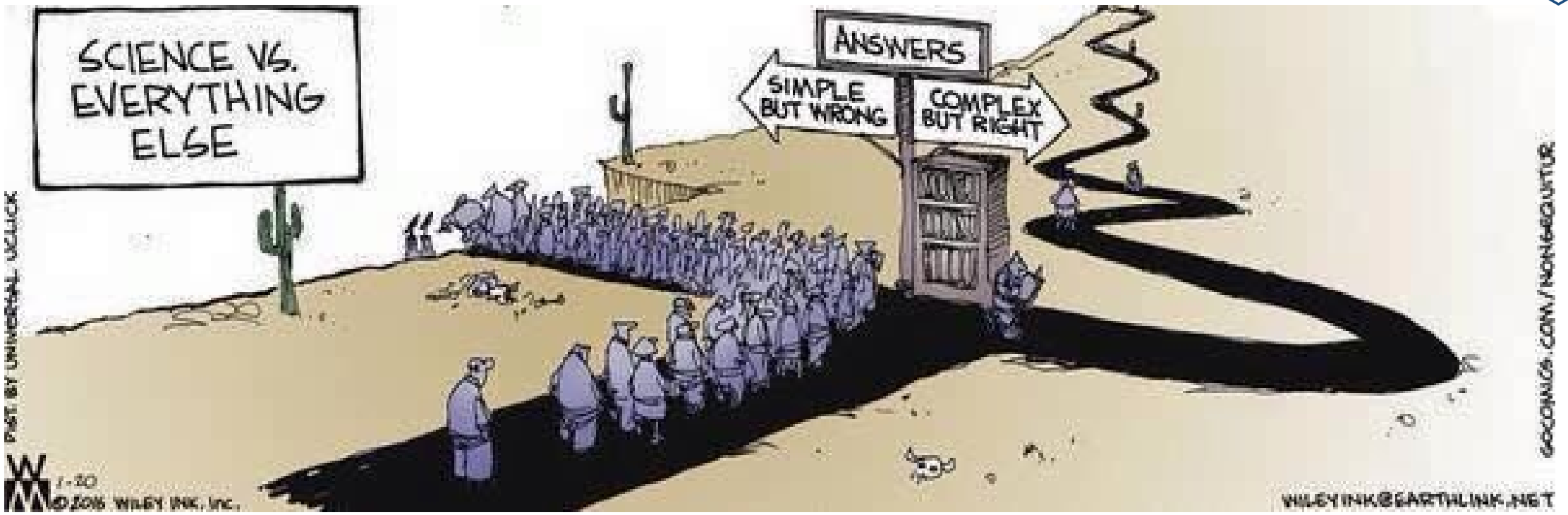
The Model is Not the Reality III

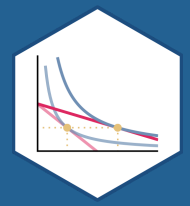


Source: SMBC

"Shame on the three of you who enjoyed this joke"

The Model is Not the Reality III

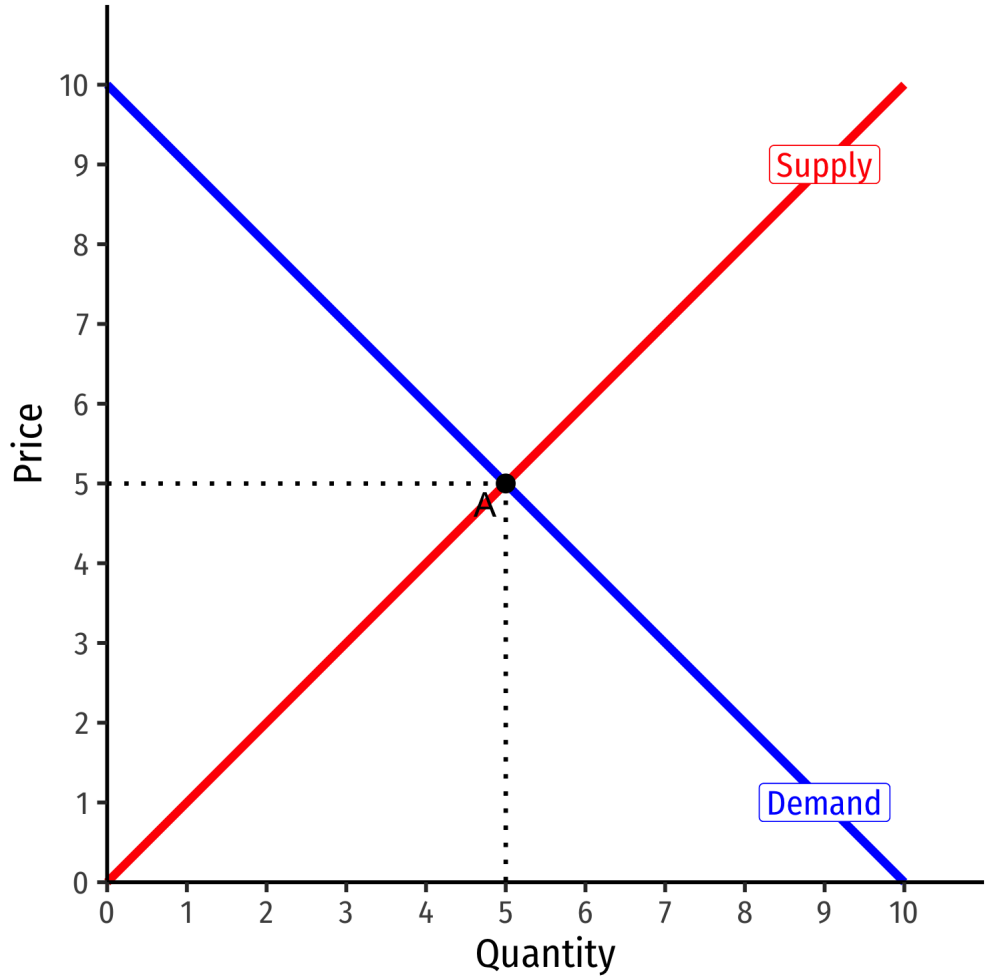




Why Markets Tend to Equilibrate, Redux

The Law of One Price I

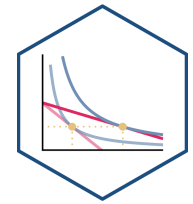
- **Law of One Price**: *all* units of the *same* good exchanged on the market will tend to have the same market price (the market-clearing price, p^*)



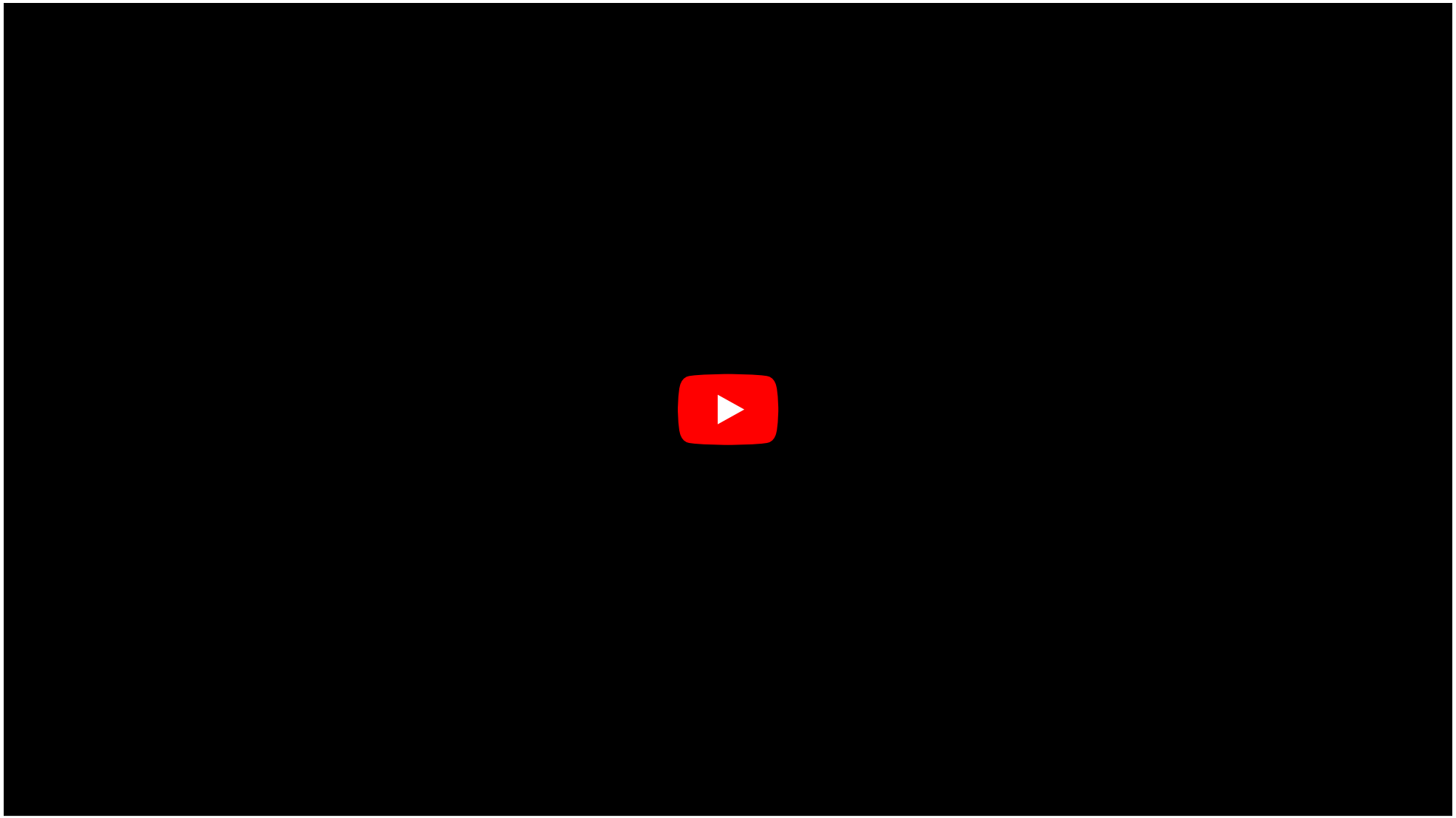
The Law of One Price II

- Consider if there are *multiple* different prices for *same* good:
- **Arbitrage** opportunities: optimizing individuals recognize **profit opportunity**:
  - Buy at low price, resell at high price!
  - There are possible gains from trade or gains from innovation to be had
- **Entrepreneurship**: recognizing profit opportunities and entering a market as a seller to try to capture gains from trade/innovation

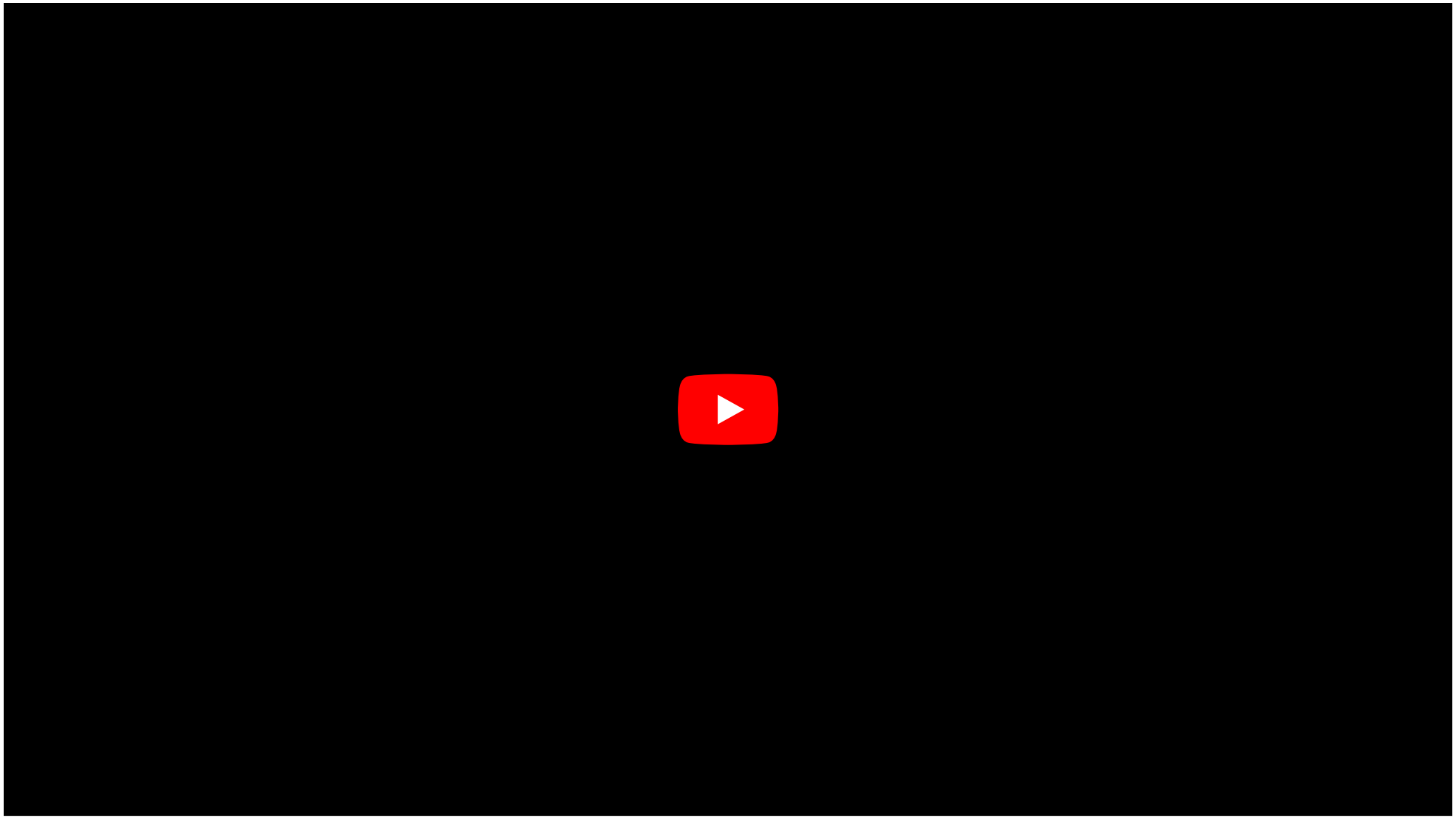
Arbitrage and Entrepreneurship I



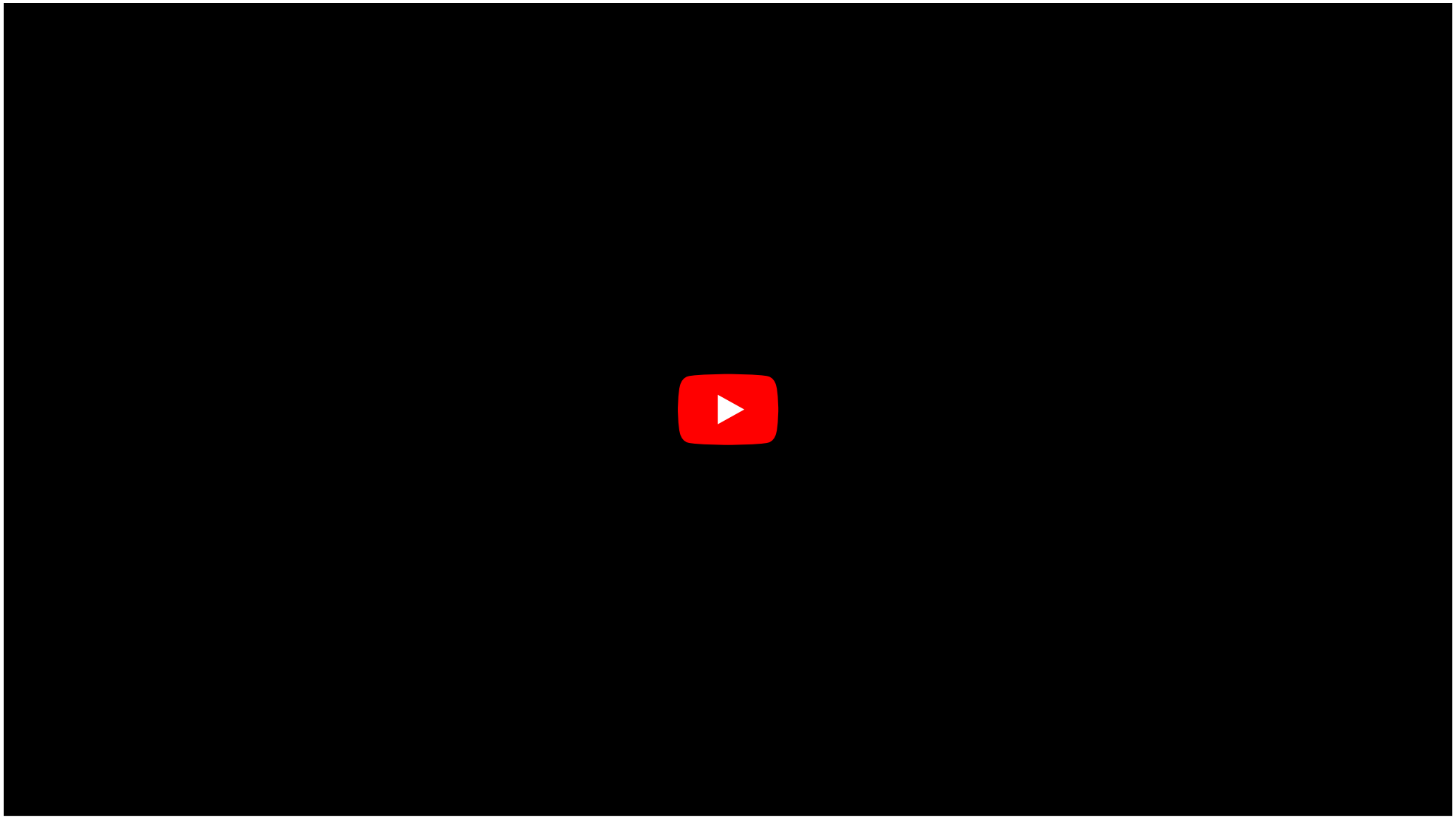
Arbitrage and Entrepreneurship II



Arbitrage and Entrepreneurship III



Uncertainty vs. Risk



Uncertainty vs. Risk

- **“Known knowns”**: perfect information
- **“Known unknowns”**: risk
  - We know the probability distribution of states that *could* happen
  - We just don't know *which* state will be realized
  - We can estimate probabilities, maximize expected value, minimize variance, etc.

Uncertainty vs. Risk

- **“Unknown unknowns”**: uncertainty
  - We don’t even know the probability distribution of states that *could* happen
  - *No model to optimize* in a world of uncertainty!

The Role of Entrepreneurial Judgment

- Under true **uncertainty**, it's not that we can't assign probabilities to each outcome; we do not even have the knowledge necessary to list all possible outcomes!
- Requires **entrepreneurial judgment** to *both*:
    1. estimate possible actions *and*
    2. estimate the likelihood of their success
- **Entrepreneur** is central player, earns pure profits (a residual) for *bearing uncertainty*

For more, see Knight 1920 in today's readings.

Entrepreneurial Judgment

Henry Ford

1863-1947

> “If I had asked people what they wanted, they would have said **faster horses**.” - Henry Ford

Entrepreneurial Judgment

> “It's really hard to design products by focus groups. A lot of times, **people don't know what they want until you show it to them**.” - Steve Jobs

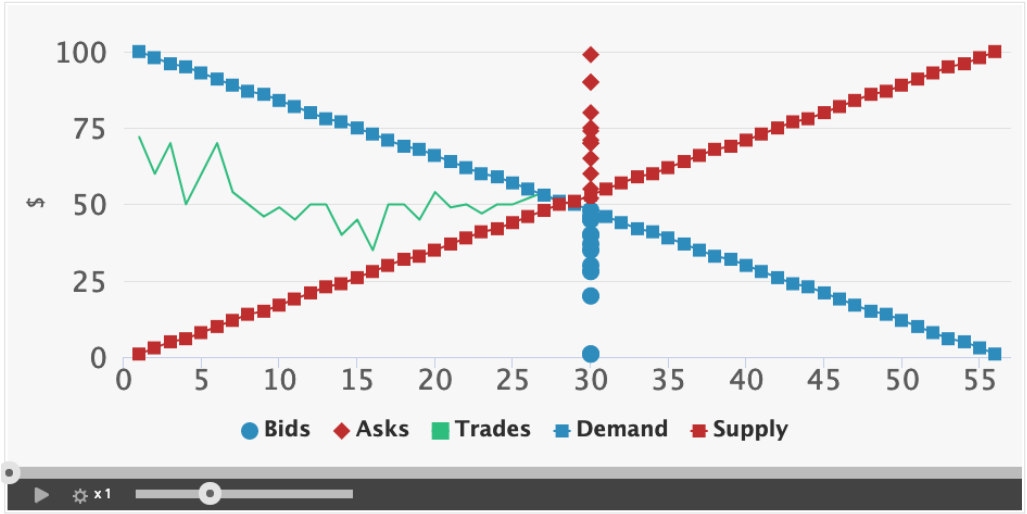
Uncertainty and Entrepreneurship

Mark Zuckerberg

1984-

> "Why were we the ones to build [Facebook]? We were just students. We had way fewer resources than big companies. If they had focused on this problem, they could have done it. The only answer I can think of is: **we just cared more**. **While some doubted** that connecting the world was actually important, **we were building**. While others doubted that this would be sustainable, **we were forming lasting connections**."

How Markets Get to Equilibrium I



STATS

TOTAL EARNINGS:	POSSIBLE EARNINGS:	EFFICIENCY
$ 1243	$ 1410	88.16%

- Nobody knows "the right price" for things
- Each buyer and seller only know **their own** reservation prices
- Buyers and sellers adjust their bids/asks
- Markets do not *start* competitive, but *become* competitive!
- New entrepreneurs enter to try to capture gains from trade/innovation
- As these gains are exhausted, prices converge to equilibrium

How Markets Get to Equilibrium II

For more, see Hayek 1945 in today's readings.

- Errors and imperfect information

  $\Longrightarrow$ multiple prices

  $\Longrightarrow$ arbitrage opportunities

  $\Longrightarrow$ entrepreneurship

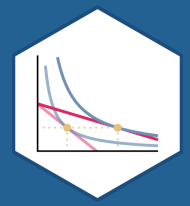
  $\Longrightarrow$ correcting mistakes

  $\Longrightarrow$ people update their behavior & expectations

- Markets are **discovery processes** that *discover* the right prices, the optimal uses of resources, and cheapest production methods, none of which can be known in advance!

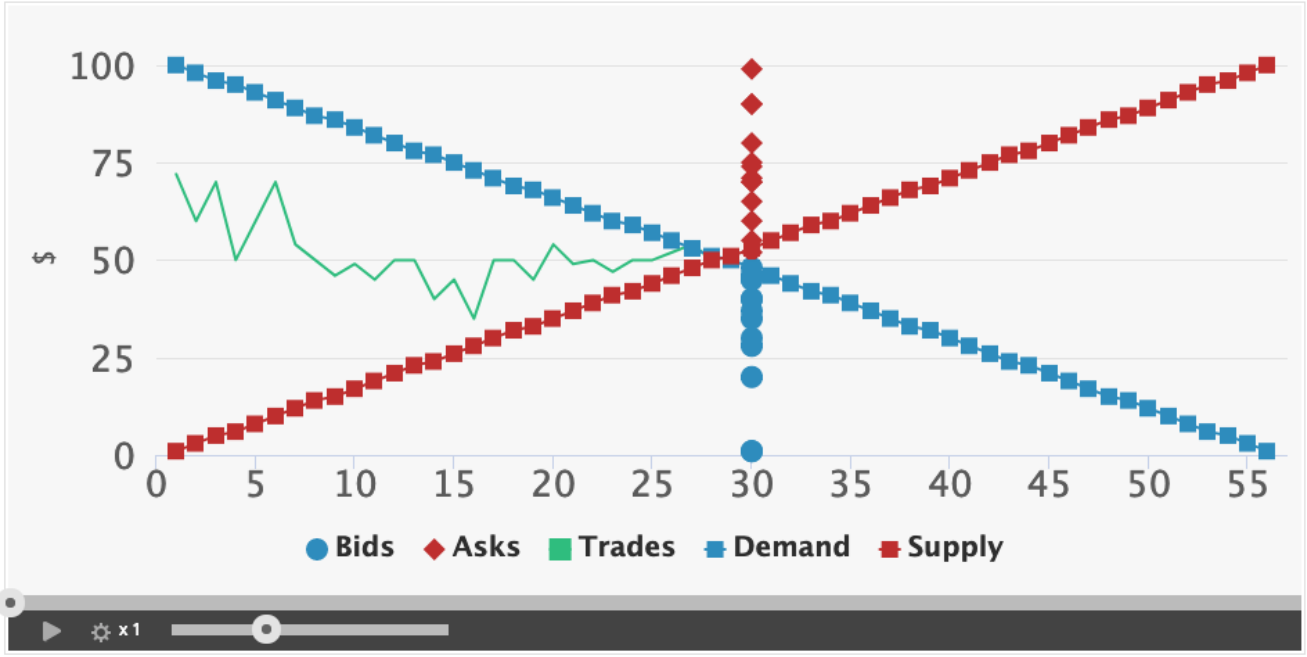
How Markets Get to Equilibrium III

- Economy as a **cat**-and-**mouse** game between:
  - **Mouse**: preferences, technologies, alternative uses of resources
  - **Cat**: market prices, least-cost technologies
- **Cat** always chasing **mouse**
  - **Mouse** *always* moving
  - Any time **cat** hasn't caught **mouse**: profit opportunities
- **IF** **mouse** *froze*, market would rest at equilibrium



The Social Functions of Market Prices

Prices are Signals I



STATS

TOTAL EARNINGS:	POSSIBLE EARNINGS:	EFFICIENCY
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Prices are Signals II

- **Markets are social *processes* that generate information via prices**
- **Prices are never "given"**, prices **emerge** dynamically from negotiation and market decisions of entrepreneurs and consumers
- **Competition**: is a **discovery process** which *discovers* what consumer preferences are and what technologies are lowest cost, and how to allocate resources accordingly

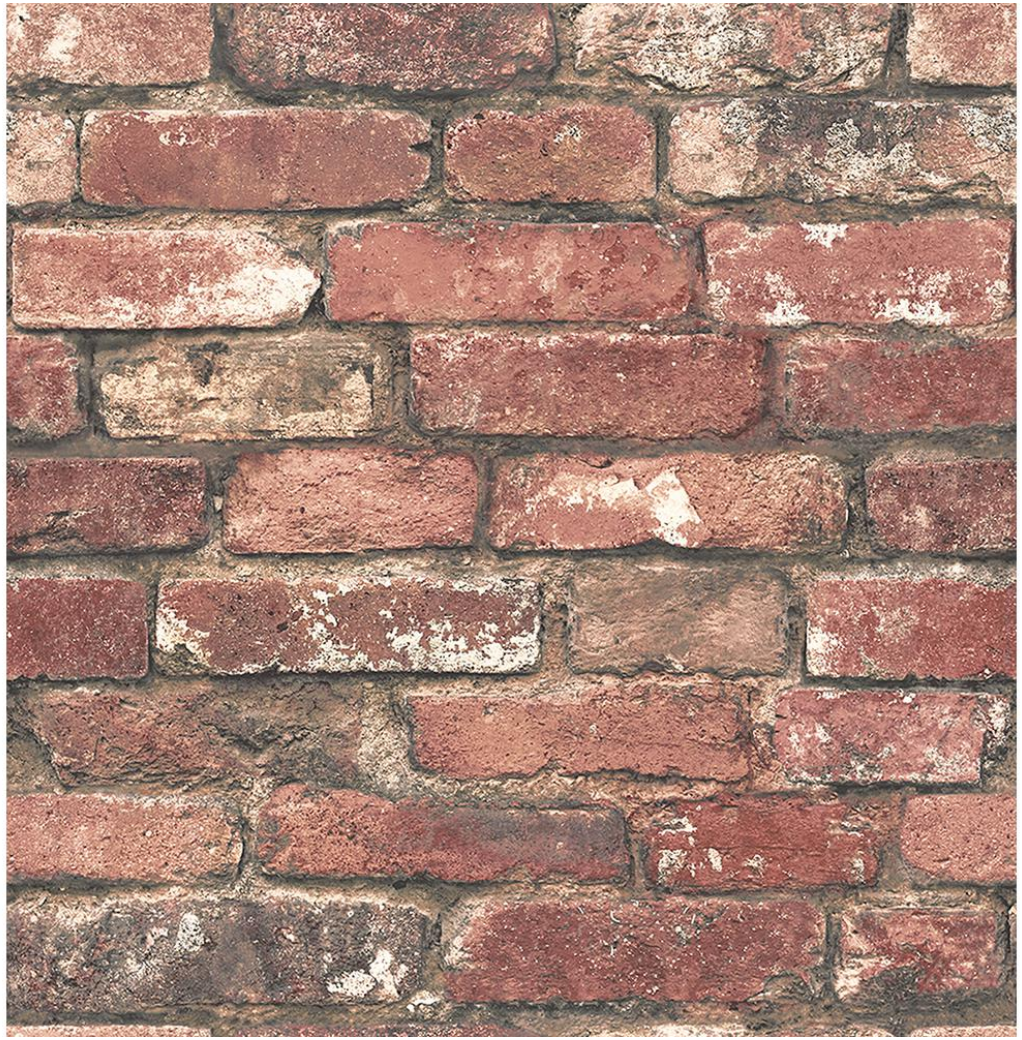
For more, see Hayek 1945 in today's readings.

The Social Functions of Prices I

A relatively high price:

- **Conveys information**: good is relatively scarce
- **Creates incentives for**:
  - **Buyers**: conserve use of this good, seek substitutes
  - **Sellers**: produce more of this good
  - **Entrepreneurs**: find substitutes and innovations to satisfy this unmet need

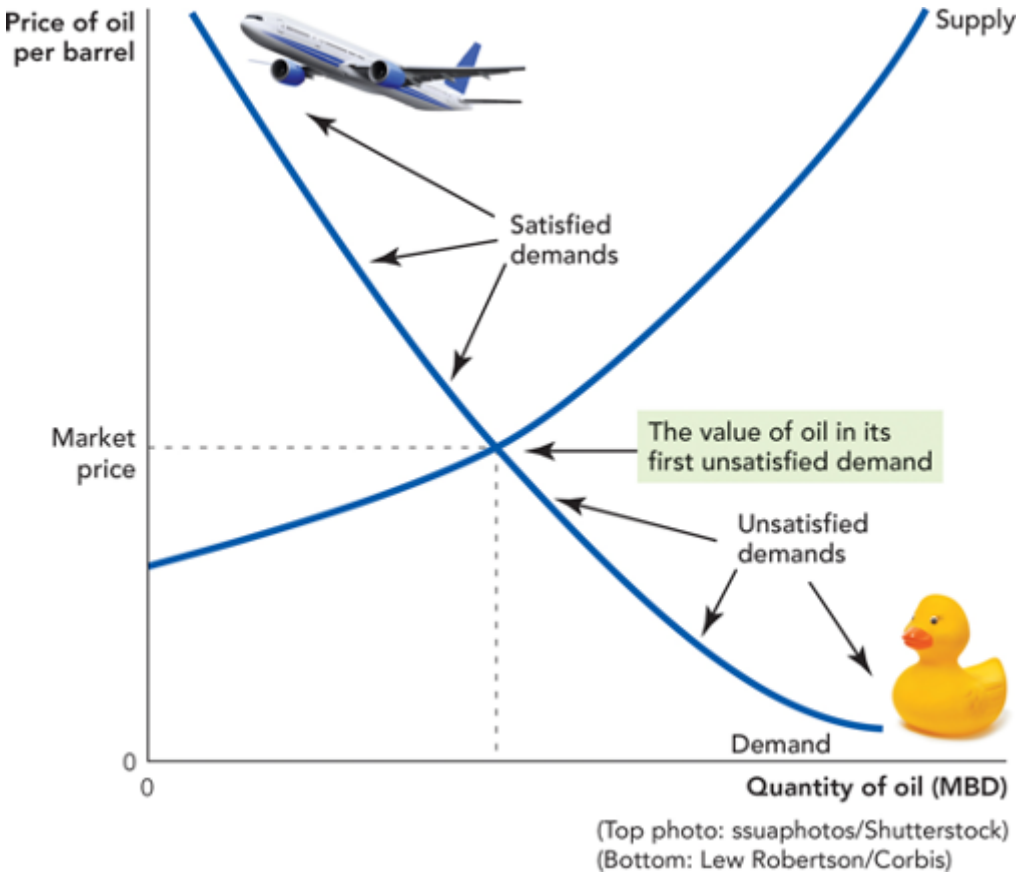
The Social Functions of Prices II



A relatively low price

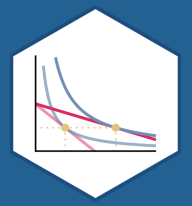
- **Conveys information**: good is relatively abundant
- **Creates incentives for**:
  - **Buyers**: substitute away from expensive goods towards this good
  - **Sellers**: Produce less of this good, talents better served elsewhere
  - **Entrepreneurs**: talents better served elsewhere: find more severe unmet needs

The Social Functions of Prices III



(Top photo: ssuaphotos/Shutterstock)
(Bottom: Lew Robertson/Corbis)

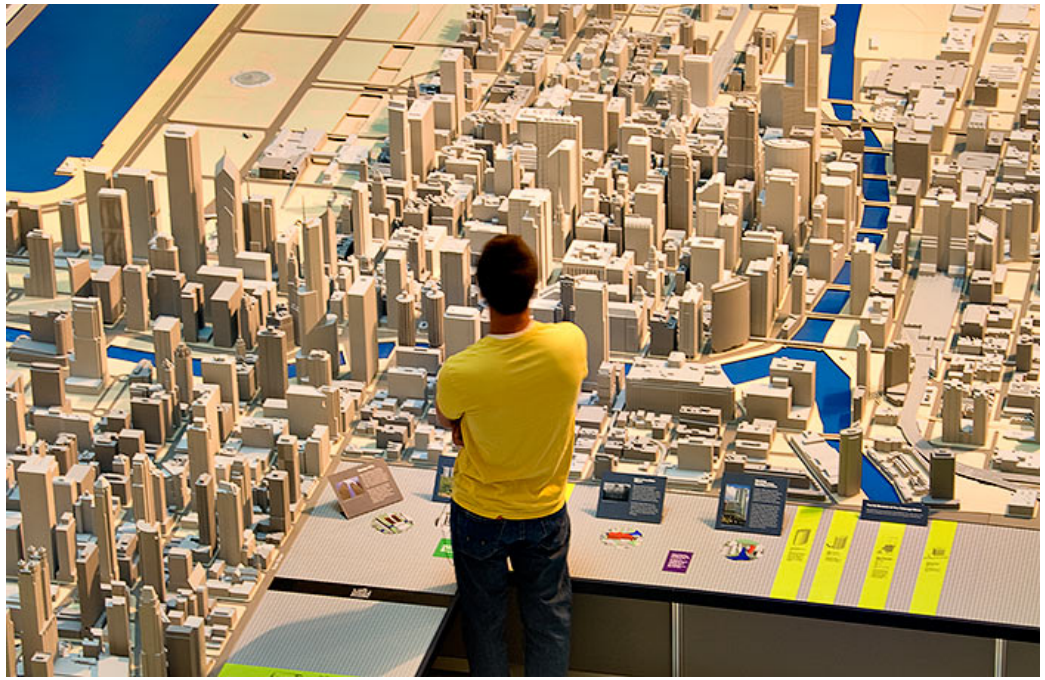
- **Prices tell us how to allocate scarce resources among competing uses**
- Think of diminishing marginal utility:
  - allocate scarce good to highest-valued use first
  - as supply becomes more plentiful (price falls), can allocate more units of the good to lower-valued uses (higher-valued uses already satisfied)



Uncertainty and Profits

Uncertainty, Tacit Information, and Profit I

- **Economic theory**: in a perfectly competitive market, in the long run, economic profit $\longrightarrow$ to zero
- **Real world**: there *are* often economic profits
- Our blackboard models assume perfect information
- In reality we have to deal with **uncertainty**



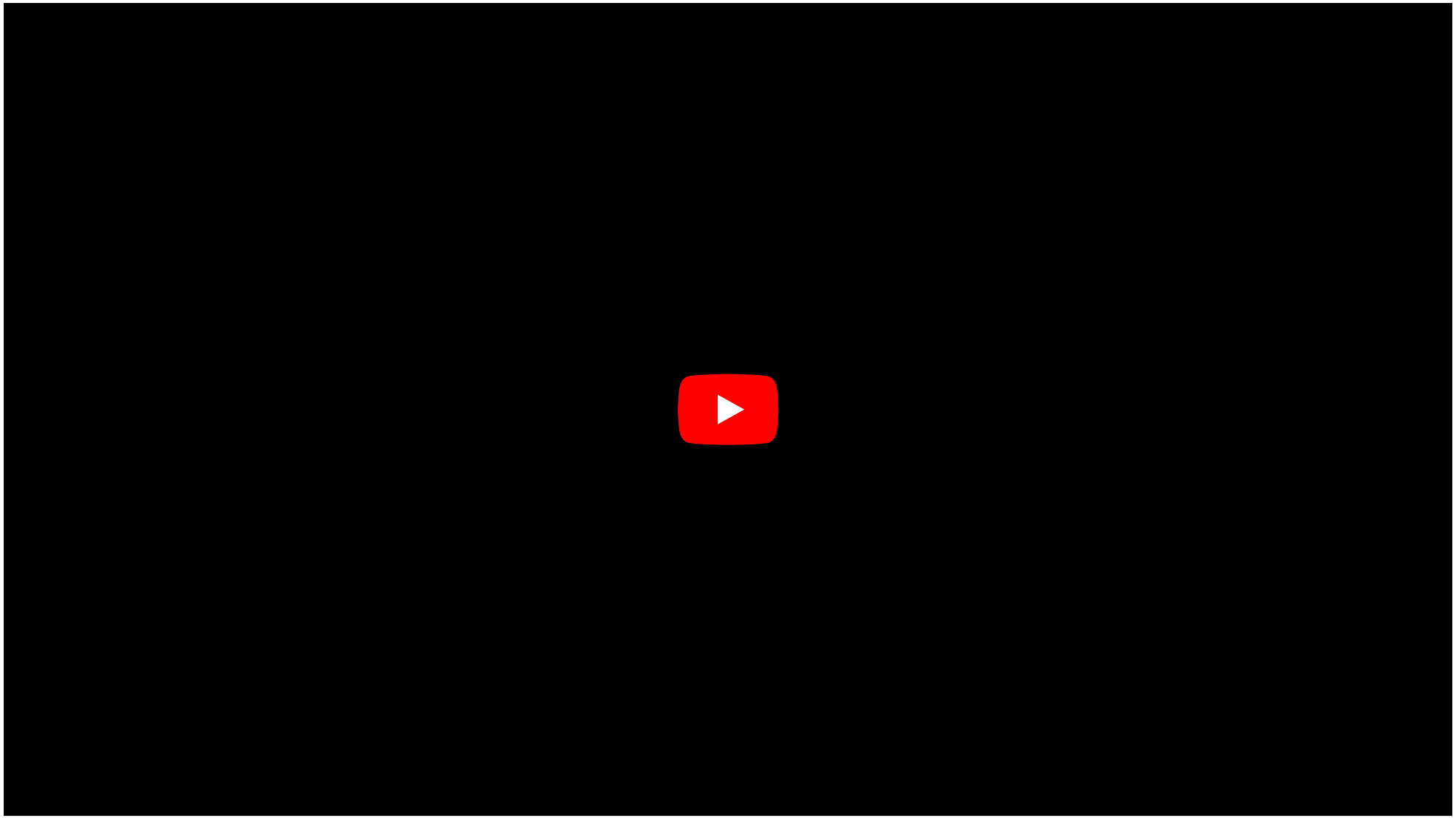
Uncertainty, Tacit Information, and Profit II

- Imperfect information: mispricing and multiple prices $\longrightarrow$ arbitrage/profit opportunities
    - Some people recognize opportunities ($20 bills) that others do not see
- **In a world of certainty, there would be no profit**
    - The model world of perfect competition is a fictional world of certainty
    - The real world, *because* it's uncertain, *has* profit opportunities!

Uncertainty, Tacit Information, and Profit III

- Firms don't actually *maximize* profits 😨, just a convenient assumption!
    - In a world of uncertainty (unlike mere risk), there's no way to *maximize* anything!
- Real world is *not* a mere constrained maximization problem!
- Better to think in **evolutionary** terms:
    - Firms that *best* adapt to market circumstances will *survive* and earn profit...whether by skill & talent or just dumb luck!

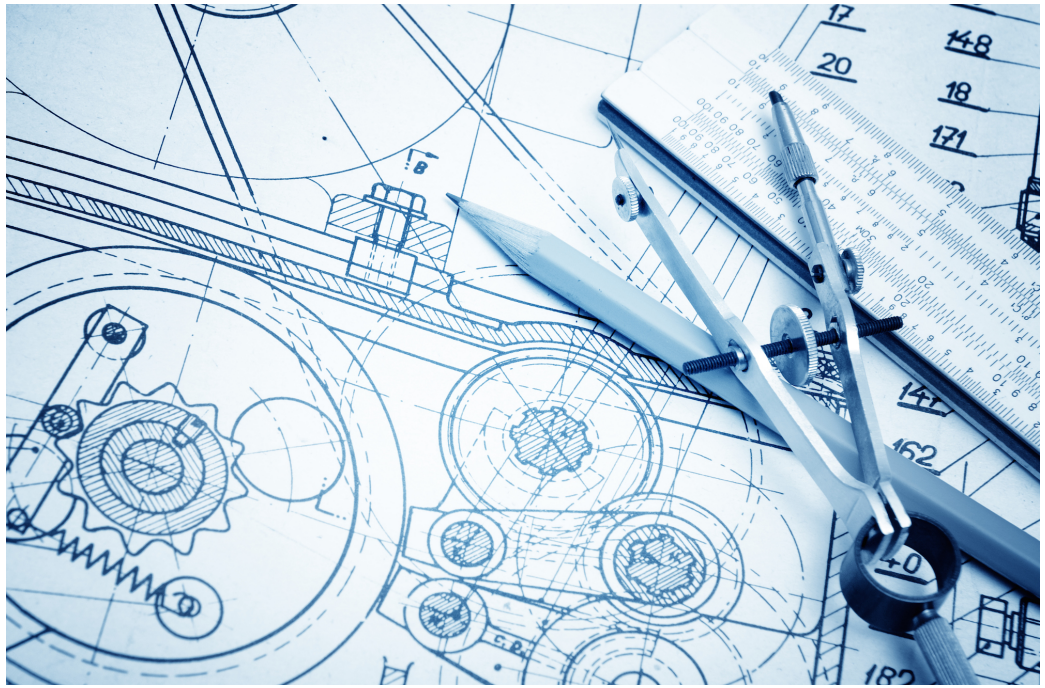
Uncertainty, Tacit Information, and Profit IV



Reminder: Profits and Entrepreneurship

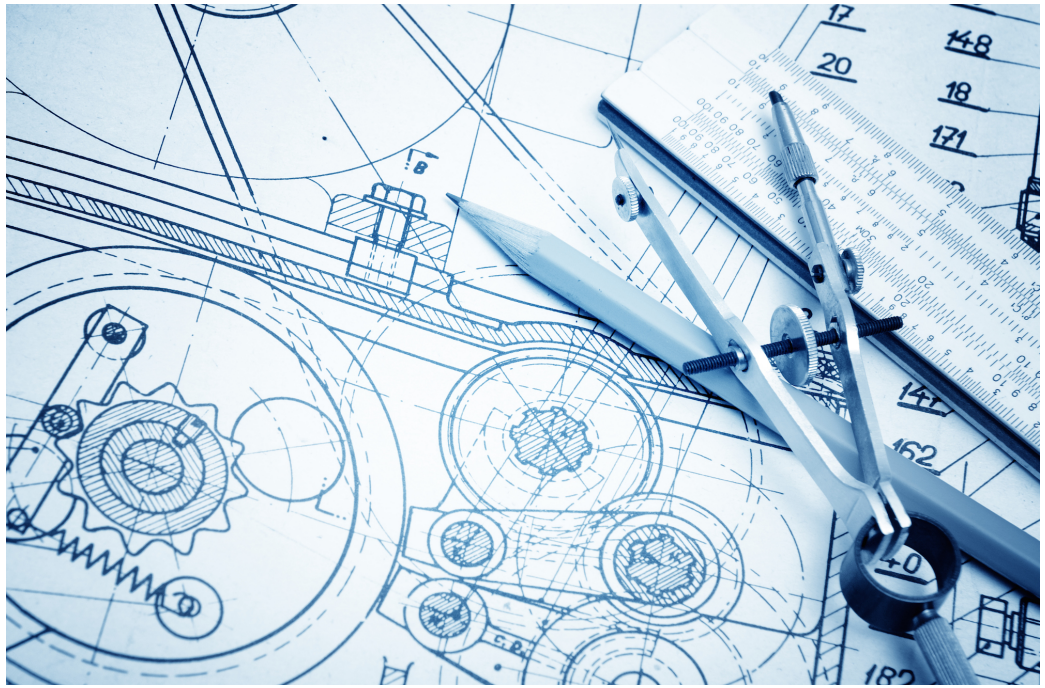
- In markets, production faces **profit-test**:
  - **Is consumer's willingness to pay > opportunity cost of inputs?**
- Profits are an indication that **value is being created for society**
- Losses are an indication that **value is being destroyed for society**
- Survival for sellers in markets *requires* firms continually create value and earn profits or die

Why We Need Prices, Profits, and Losses I



- People often confuse the **economic problem** with a **technological problem**
- **Technological problem**: how to allocate scarce resources to accomplish a particular goal
    - e.g. buy the right combination of goods to maximize utility
    - e.g. buy the right combination of inputs and produce output to maximize profits
    - given stable prices, preferences, and technologies, **a computer can solve this problem**

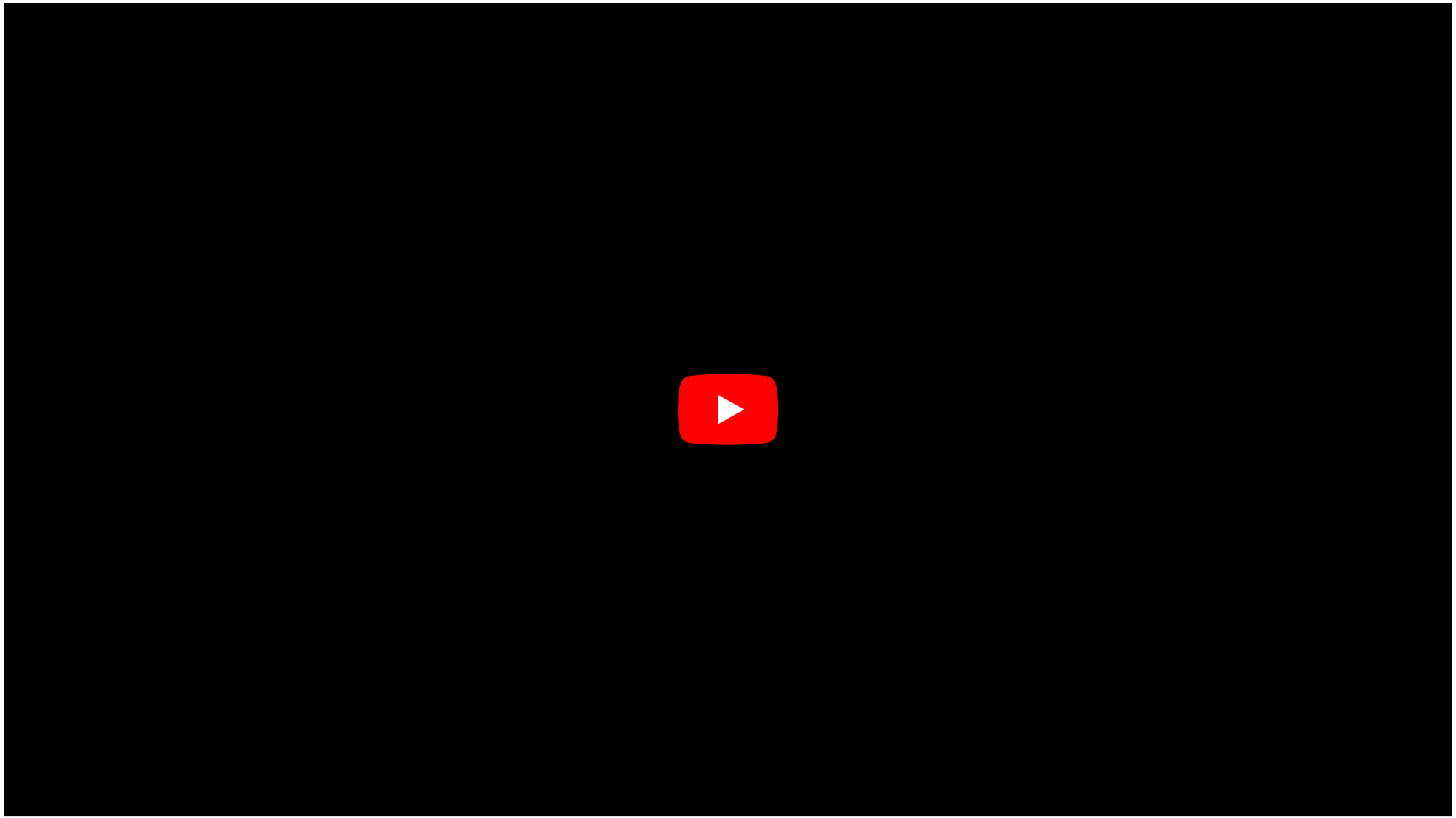
Why We Need Prices, Profits, and Losses II



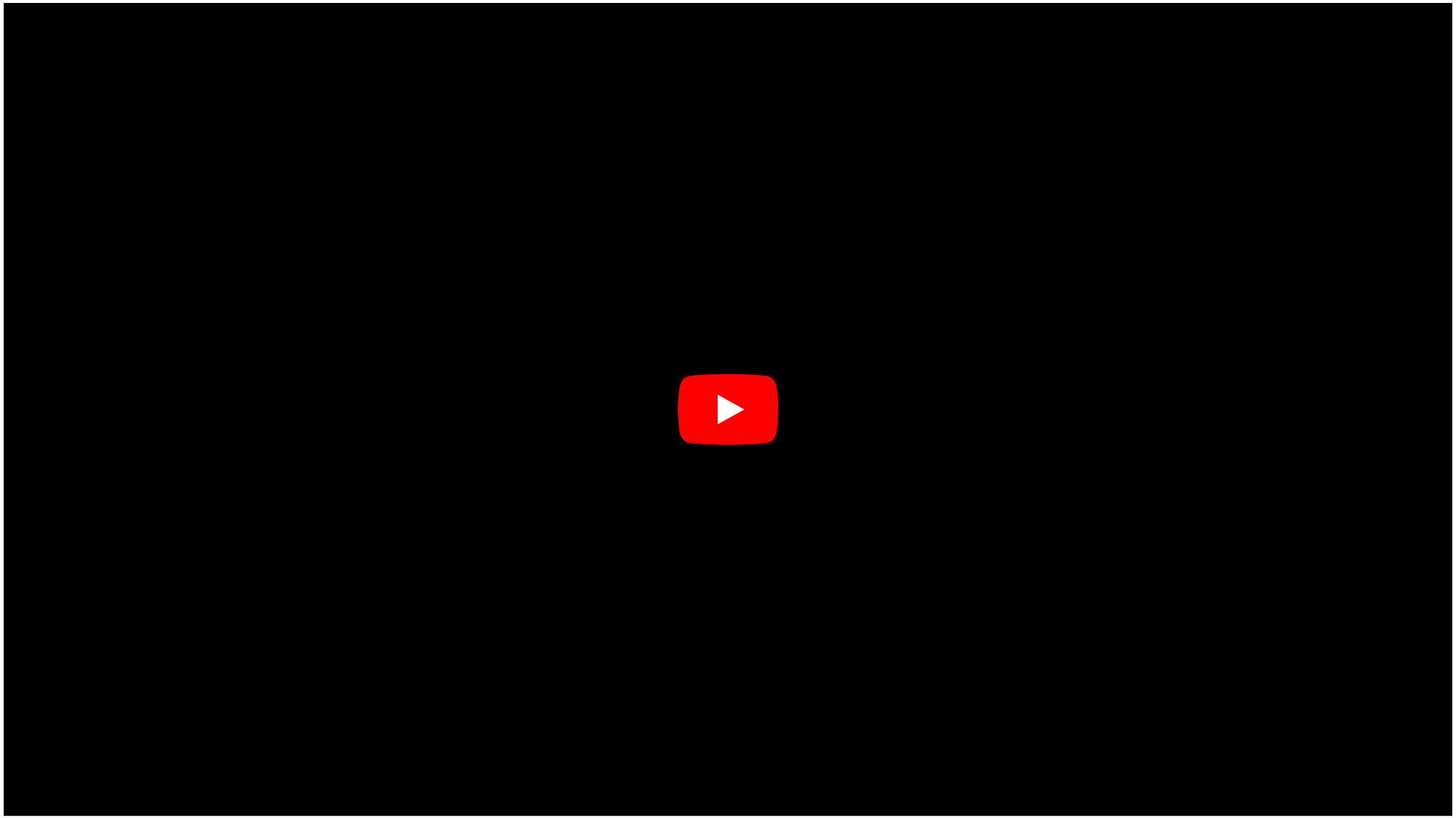
- **Economic calculation problem**: how to determine which of the infinite technologically-feasible options are *economically* viable?
- **How to best make use of dispersed knowledge to coordinate conflicting plans of individuals for their own ends?**
- ONLY can be **discovered** through competition, prices, profits & losses

For more, see Hayek 1945 in today's readings.

What if there Were No Prices? I



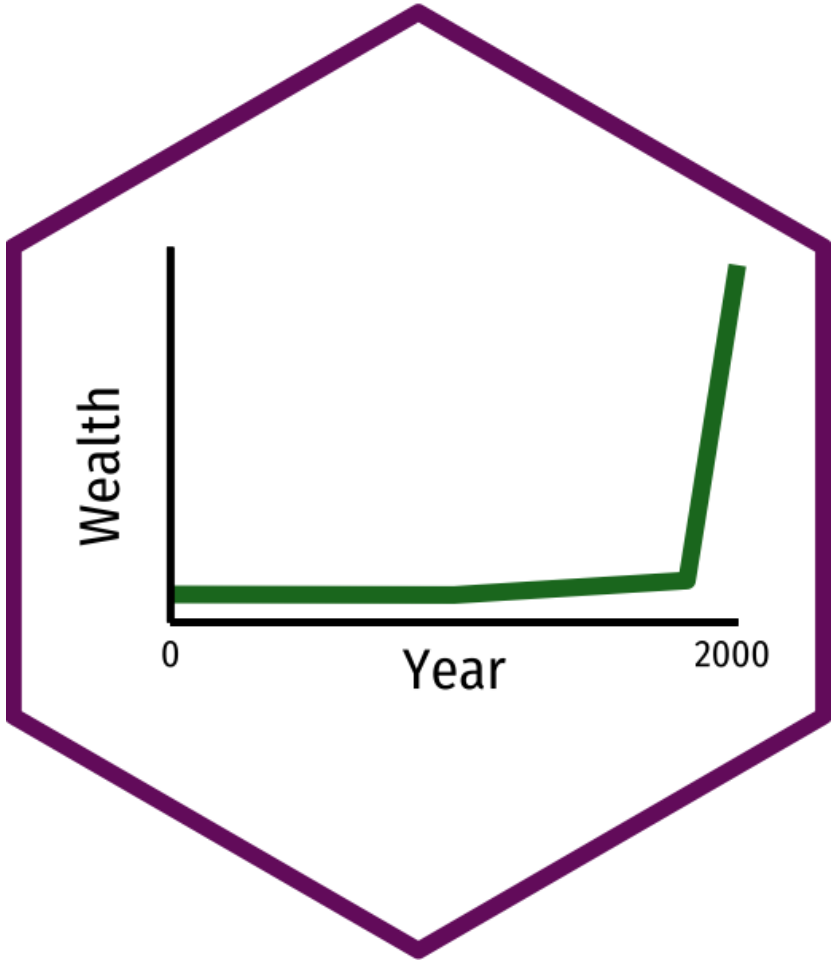
What if there Were No Prices? II



For More On The Socialist Calculation Debate

See lesson 4.2 in my History of Economic Thought Course: The Socialist Calculation Debate

And How Did The Soviet Union "Work" For So Long?



See lesson 12 in my Economics of Development Course: Russia and the Post-Communist Transition