THE INVISIBLE HAND AND THE MARKET ECONOMY

CLASS NOTES

THE ECONOMICS OF GLOBALIZATION
Dr. Jesus Sandoval-Hernandez
College of Charleston
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I. THE INVISIBLE HAND

"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 self-interest... [Every individual] intends only his own security, only his own gain. And he is in this led by an invisible hand to promote an end which was no part of his intention. By pursuing his own interest, he frequently promotes that of society more effectually than when he really intends to promote it."

The invisible hand indicates situations when self-interest leads to the social interest. The market mechanism of supply and demand communicates the wants of consumers to businesses and through businesses to resource suppliers. Competition forces business and resource suppliers to make appropriate responses. The impact of an increase in consumer demand for some product will raise that good's price. The resulting economic profits signal other producers that society wants more of the product. Competition simultaneously brings an expansion of output and a lower price.
The Romance

- Roses in February in Chicago. Quite incredible. Where do the Roses come from? Not from nearby greenhouses!

180 million roses are sold in the U.S. on a typical Valentine’s day!
Once a rose is cut in the field it is loaded onto a refrigerated truck and driven to an airport. Some roses are delivered directly to wholesalers but many are also flown to a small town, Aalsmeer in Holland.

Many roses for the US are produced in Ecuador. Millions of roses, especially for the European market, are produced in Kenya where over 100,000 people work directly in the flower industry.
At Aalsmeer the roses enter into the world’s largest commercial building, nearly 250 acres under one roof, the Bloemenveiling. In the Bloemenveiling 135,000 trolleys whisk groups of flowers to an auction. The auction is run by a special clock, a clock that ticks not time but prices – starting with a high price and ticking down until a buyer calls out buy the clock system allows flowers to be auctioned very quickly, 10,000 transactions an hour. Once a buyer has been found the flowers are then trucked back to a different set of airplanes and flown to wholesalers. Wholesaler in the United States then deliver the roses to one of the nearly 50,000 florists and supermarkets in the U.S. that sell flowers and that is where our handsome young man buys the flowers on Valentine’s day.
Markets are Cooperative

- A rose is a truly international product.
- The market for roses links romantic Americans with South American flower growers, Dutch clocks, Finnish cell phones, Colombian coffee (to keep the pilots awake) and much more.
- Hundreds of thousands of people from Ecuador to Chicago cooperated to bring the rose to our handsome young man and they did so voluntarily, on the basis of self interest, and without central direction - this is the invisible hand in action.
Markets are Creative

- When oil was cheap roses were grown in heated greenhouses in NY and PA.
- A rising price of oil in the 1970s was a signal to entrepreneurs to look for ways to use less oil so they could reduce the costs of growing roses.
- Entrepreneurs discovered that transporting millions of roses thousands of miles was cheaper and greener (!) than growing them locally so rose production moved to Ecuador, Colombia, Kenya, Thailand and other countries with warmer climates.
Markets are Connected

- Markets are connected in a complex web.
- When one price changes every other price responds as entrepreneurs recalculate and reconfigure to help solve the “great economic problem” of producing as many valuable goods as possible from our limited resources.
The rose is a symbol of worldwide cooperation.

The story of the rose demonstrates the power of trade and the creativity of entrepreneurs as they respond to the dual role of prices as signals and incentives.

The rose illustrates the invisible hand – how markets generate cooperation and coordination around the world.

http://www.youtube.com/watch?v=av6VFmMckyw&NR=1
II. INSTITUTIONS AND CHARACTERISTICS OF CAPITALISM

• Private Property
• Freedom of enterprise. – No restrictions on actions, freedom of choice and action
• “Rational Economic Man.” - Self-Interest dominates motives
• Competition
• Reliance on markets to determine prices
• Limited Role of the Government
• Use of Money.– Medium of exchange, store of value, unit of account
• Specialization, efficiency and division of labor
PERFECTLY COMPETITIVE MARKET ASSUMPTIONS

- Many small producers such that no one can influence price.
- Firms are price takers in the market. So many firms that no one firm can influence price.
- Homogeneous product
- Factor (Resource) mobility
- Perfect information — no trademarks, patents, exclusive knowledge
- Free entry and exit
- No government influence or interference
- Rationality of all market actors (maximize utility)
- Prices determined by the interaction of supply & demand