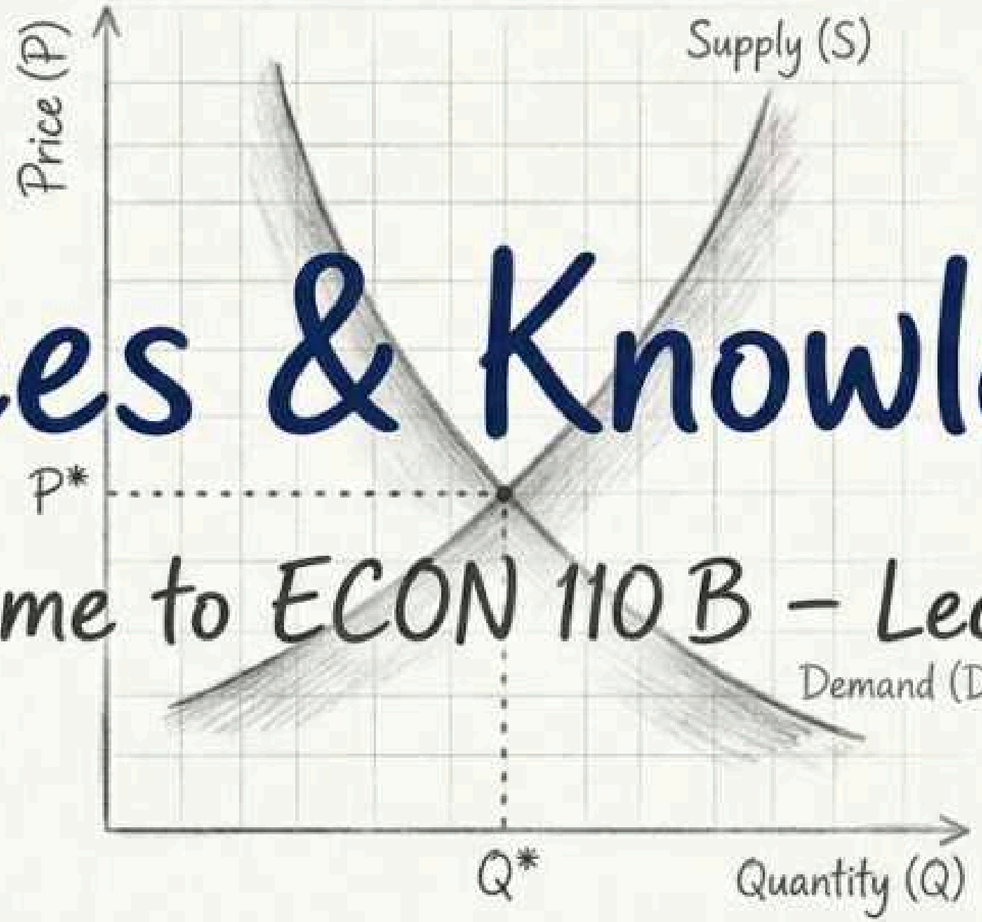
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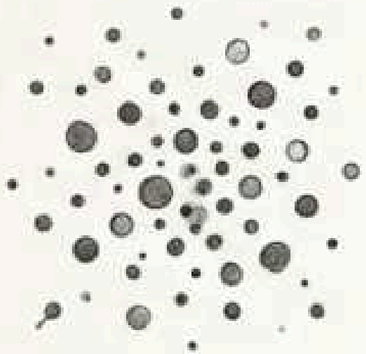
Prices & Knowledge

Welcome to ECON 110 B – Lecture 2



The Coordination of Strangers

¶ 2.2



1. Hayek & Scattered Knowledge



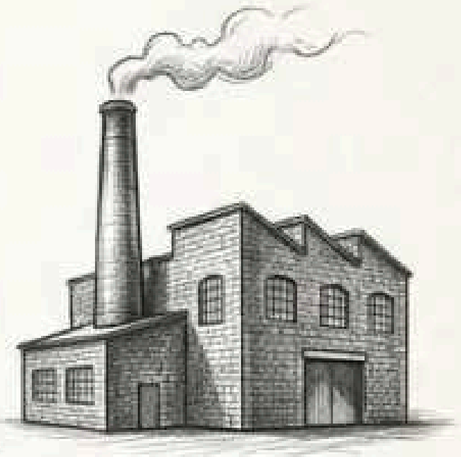
2. Prices & Profits as Signals



3. The Socialist Calculation Debate



3. The Socialist Calculation Debate



5. Limits & Why Firms Exist

¶ 2.3

The Central Economic Problem

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



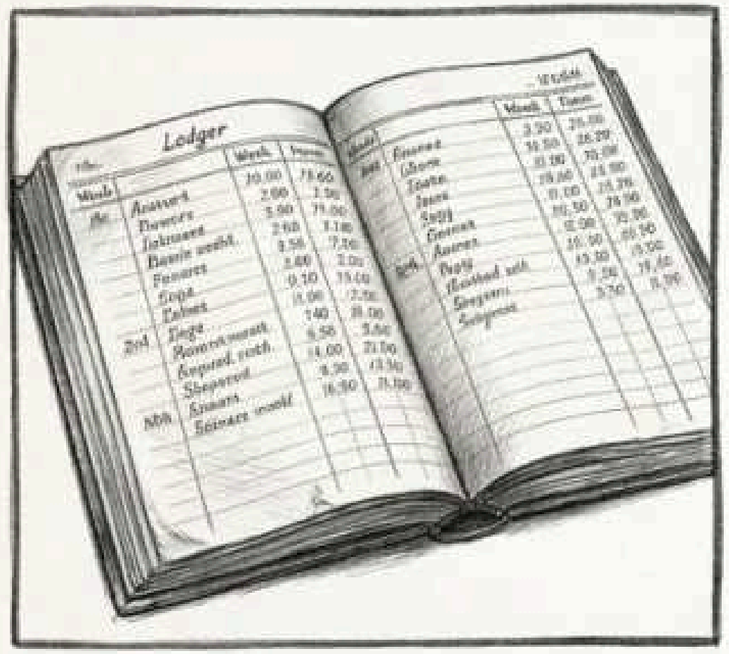
Not: Allocating resources that are already fully known.



But: Using knowledge scattered among millions of people, where no one holds more than a small piece.

The Nature of Local Knowledge

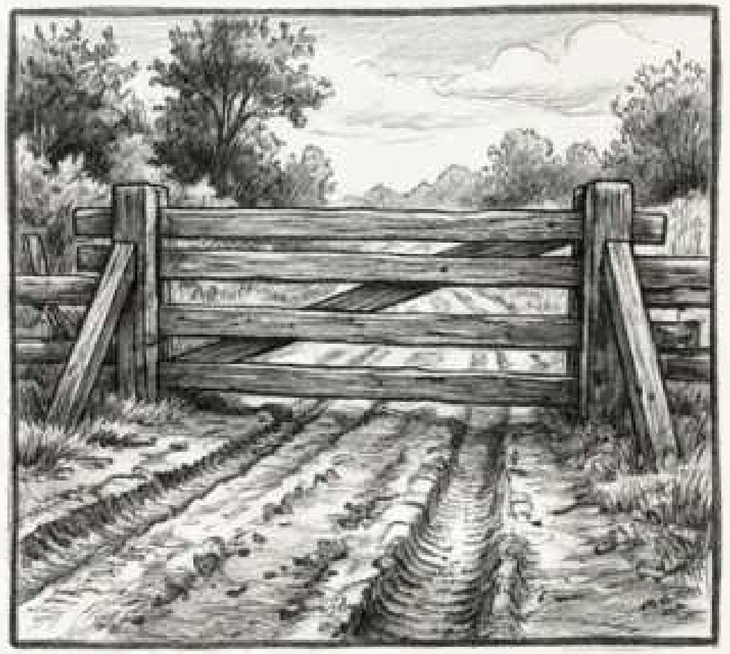
¶ 2.4



Shopkeeper: Knows which goods sell this week.



Farmer: Knows how specific soil behaves in a wet spring.



Driver: Knows which local road is currently blocked.

This knowledge is local, particular, and unwritten. It cannot be collected in a statistical report and sent to a planning office.

The Tin Example: News Without the Story

¶ 2.5



Cause: Supply lost or new demand appears somewhere.

Signal: Price becomes dearer. The price carries the news.

Action: Users economize. They never need to hear the cause.

The Millbrook Wheat Cascade



Frost destroys harvest.

Flour rises 25% ($1.00 → $1.25/kg).

Bakers use less flour / switch recipes.

Families buy more rice.

Farmers elsewhere plant more wheat next year.

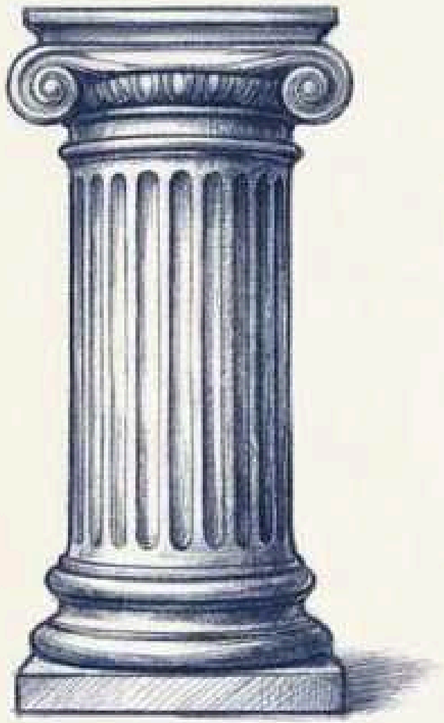
Nobody in town needed to hear about the frost.

Farmers elsewhere plant more wheat next year.

The Three Jobs of Prices

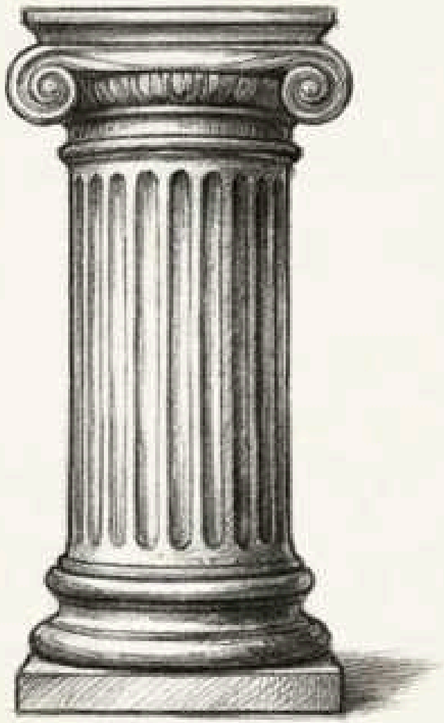
¶ 2.7

1



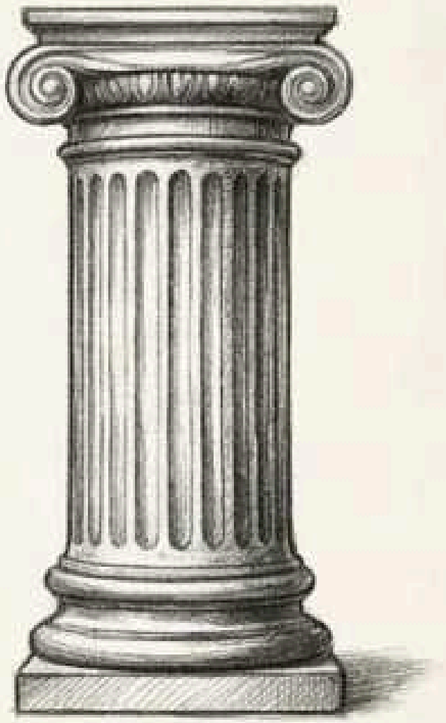
Carry information about scarcity.
(Hayek's primary emphasis)

2



Give reason to act.
Rewards suppliers; encourages users to economize.

3

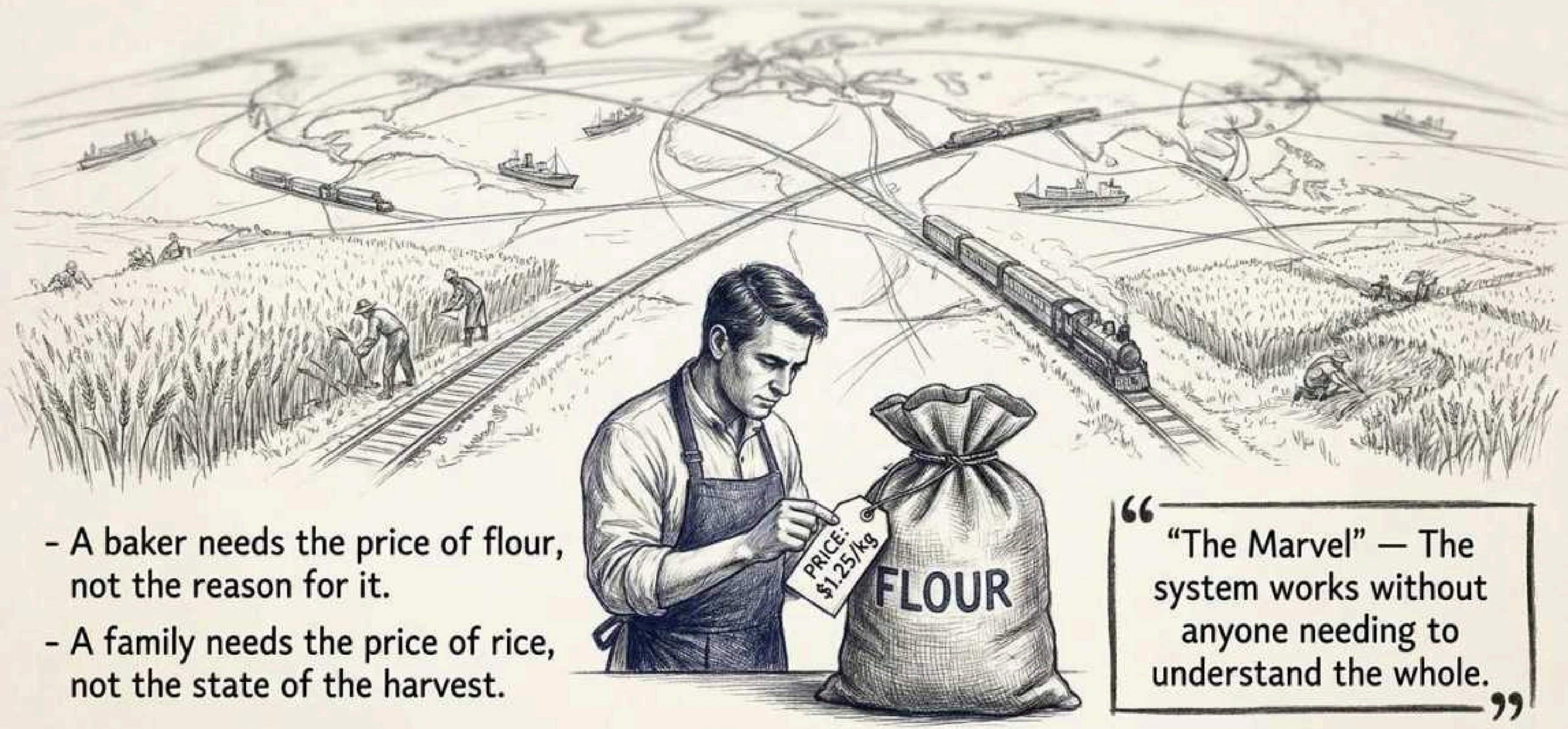


Determine incomes, deciding who can buy what.

Defenders note that Jobs 2 and 3 are what make Job 1 actually work.

Economizing on Knowledge

¶ 2.8



- A baker needs the price of flour, not the reason for it.
- A family needs the price of rice, not the state of the harvest.

> "The Marvel" — The system works without anyone needing to understand the whole.

¶ 2.9

Profits and Losses as Signals

Revenue – Cost of flour/wages/rent = Profit
($300) ($250) ($50)

↳ Meaning: Customers value the bread MORE than the resources cost.



Revenue ($240) – Cost ($250) = Loss (–$10)

↳ Meaning: Those resources are worth more elsewhere.

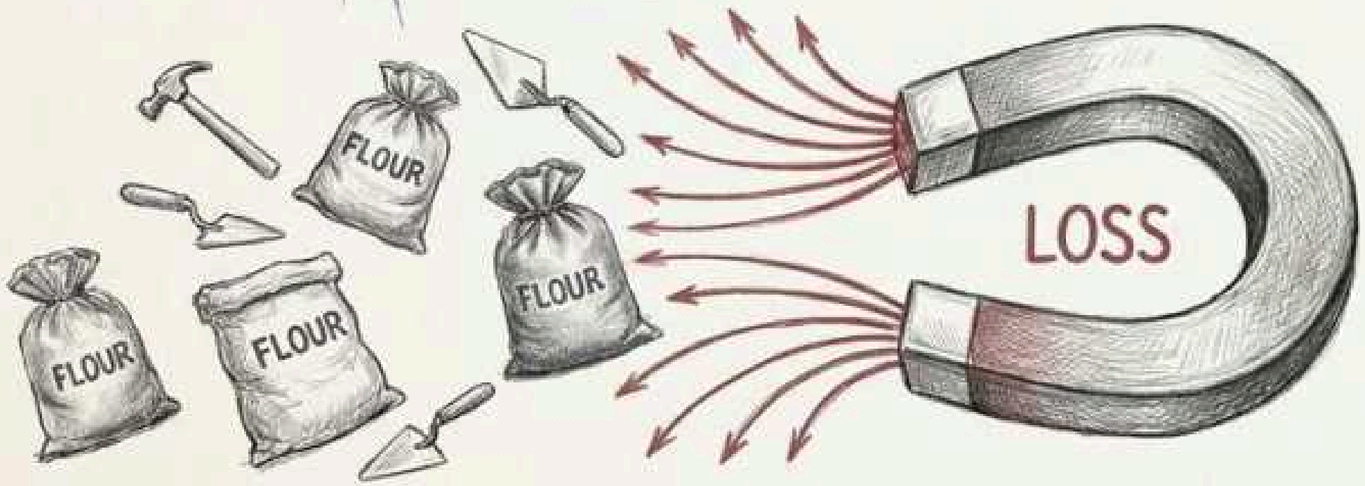
The Push, Pull, and Rivals

¶2.10





RIVALS ENTERING

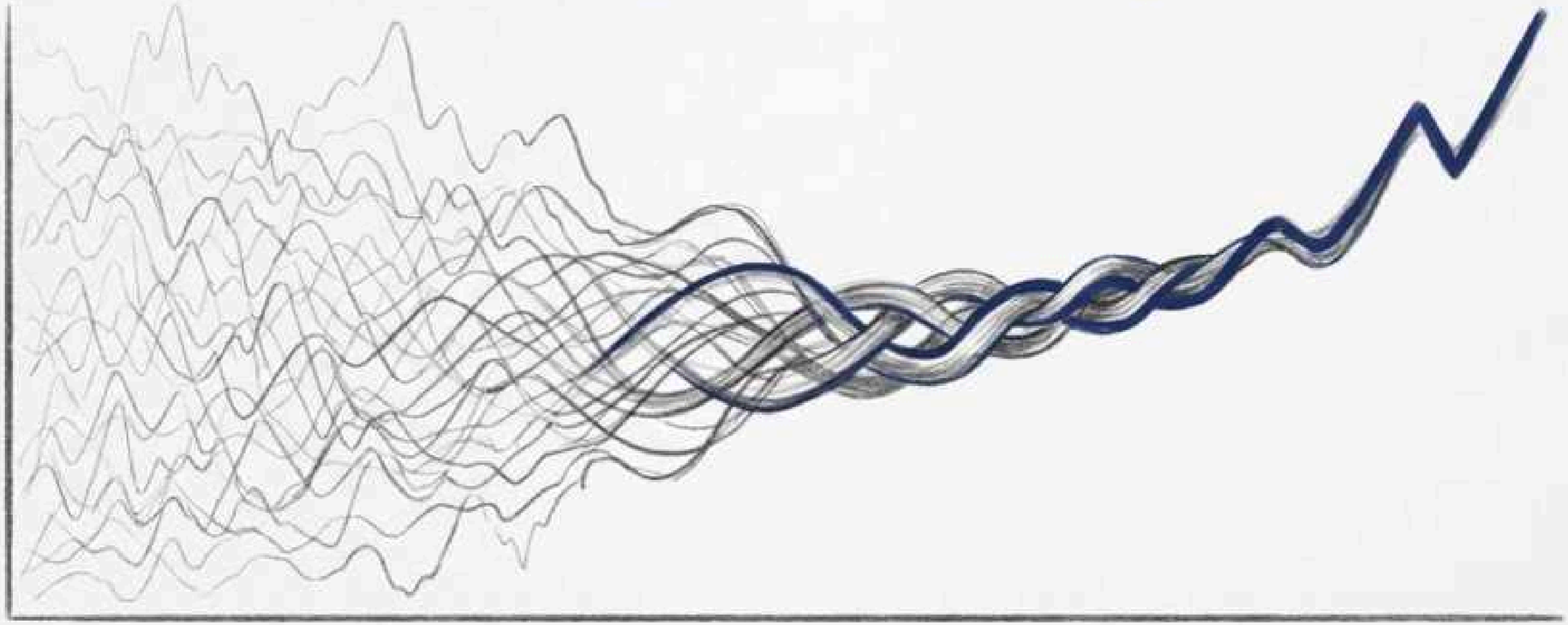


- Mechanism: Profit pulls resources toward valued uses; Loss pushes them away.

- The Discipline of Competition:

  Persistent profit invites rivals → Supply grows → Prices and profits fall back.

Pooling Knowledge



Core Concept:

Share prices reflect the combined judgment of thousands of traders.
Studies show it is hard for one person to consistently beat this combined judgment.

The Debate:

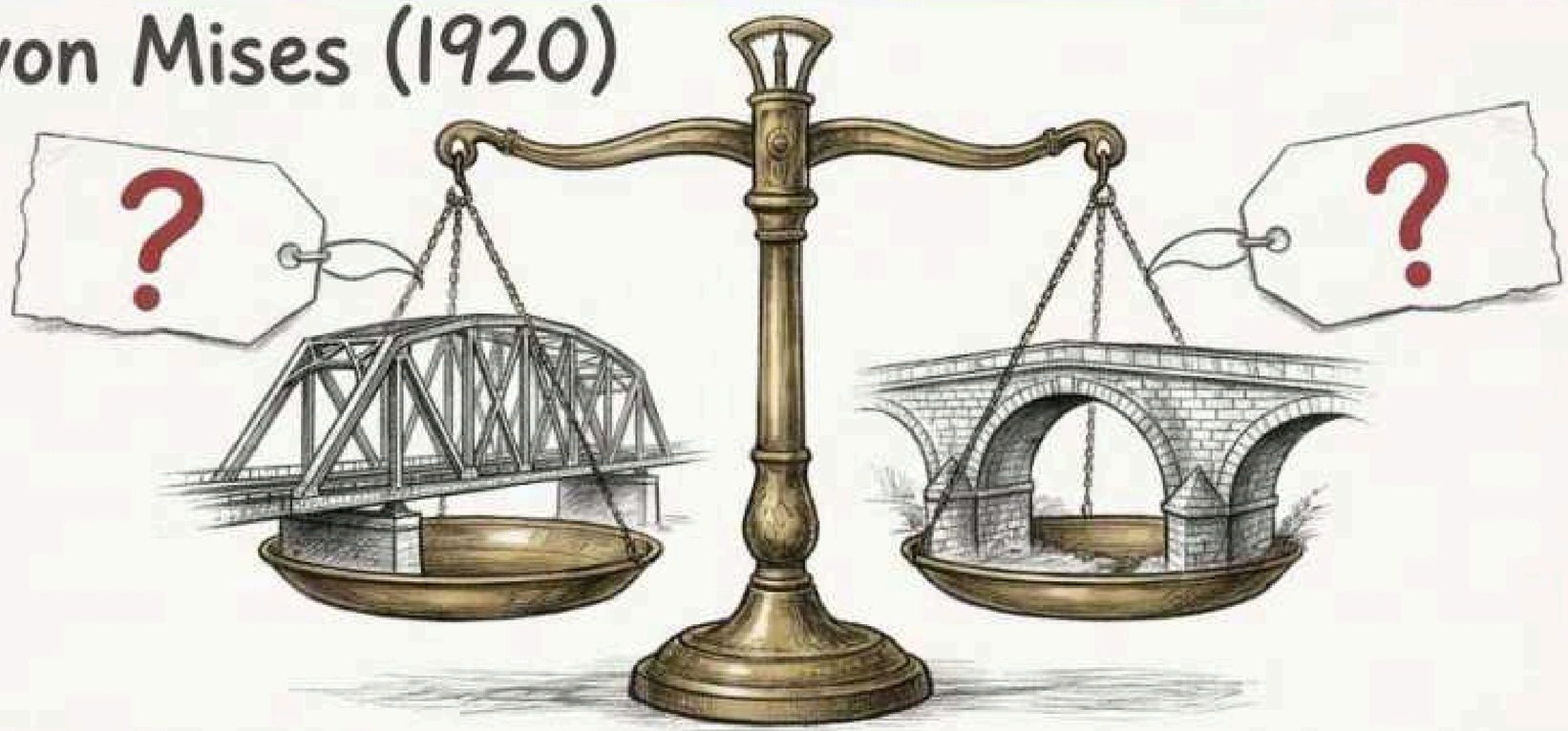
Defenders: The ultimate knowledge-pooling mechanism.

Critics: Prone to collective mistakes (bubbles).

The Socialist Calculation Problem

¶ 2.12

Ludwig von Mises (1920)

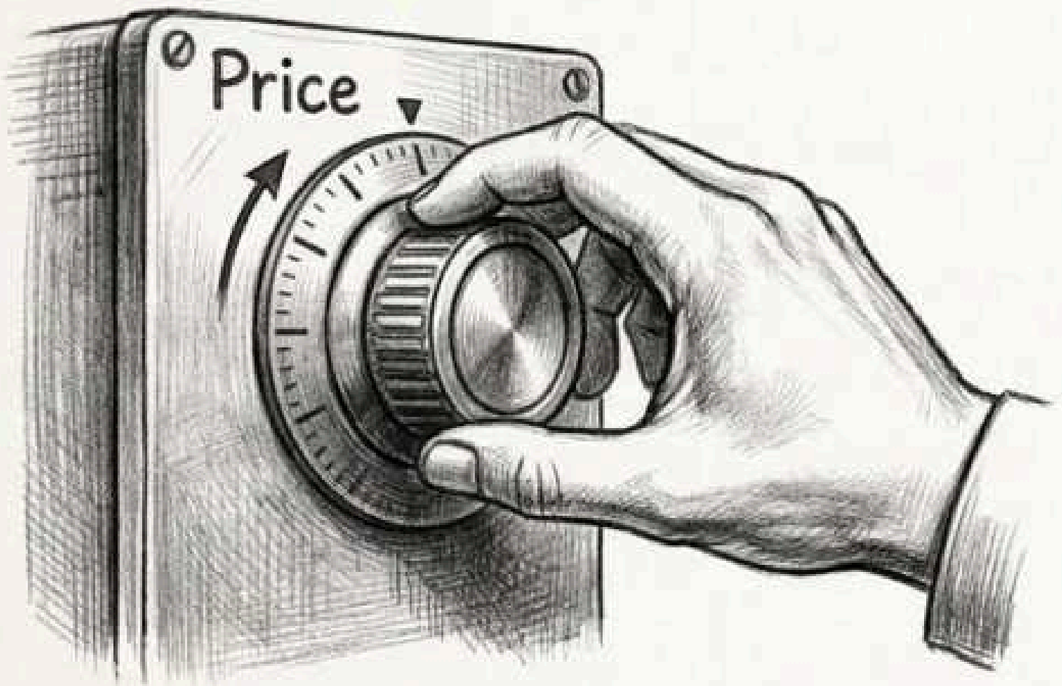


- The Dilemma: Without private ownership of capital goods, there are no market prices generated by exchange.
- The Conclusion: Without prices, a planner cannot compare costs (e.g., steel vs. stone). Rational economic calculation becomes impossible.

The Trial-and-Error Debate

¶ 2.13

Market Socialism (Lange & Lerner)



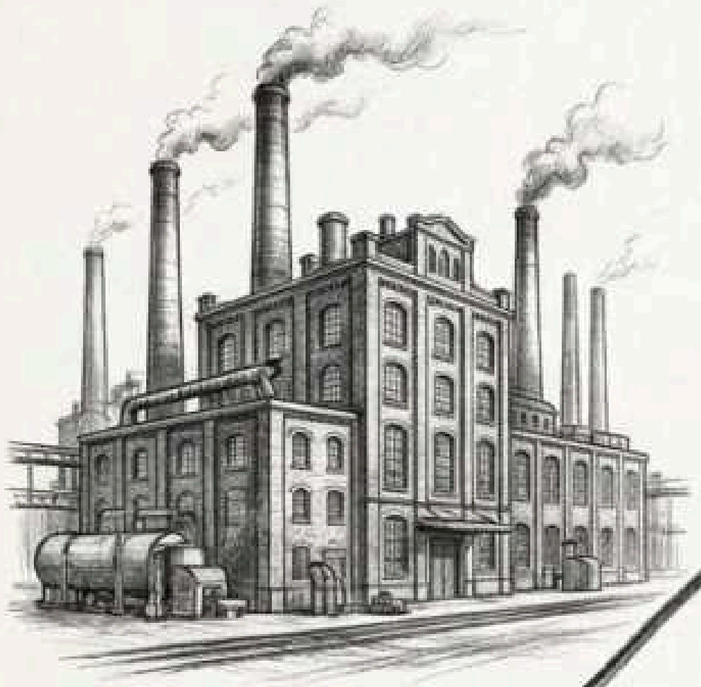
Planners' View: Officials can set prices and adjust them by trial and error.

The Discovery Process (Hayek)



Hayek's Rebuttal: Prices aren't just numbers to balance equations. Competition is a discovery process finding facts no planner can know in advance.

Central Planning in Practice





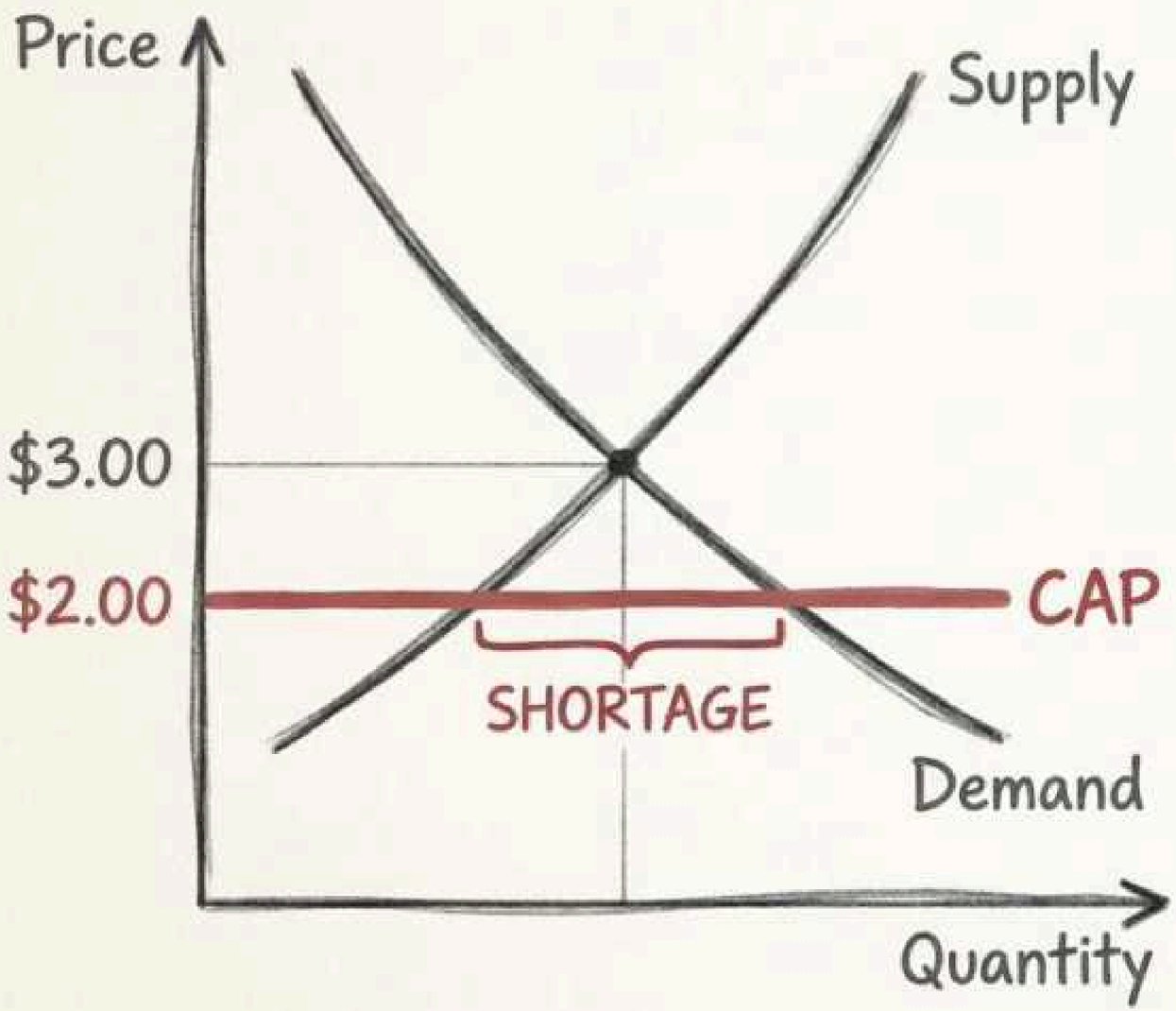
Phase 1: Fast initial growth (moving people from farms to factories).

Phase 2: Struggle to adjust, innovate, and match goods to human desires.

Result: Marked by queues, shortages, and the 1991 Soviet dissolution. Central planning performed poorly.

Price Controls Scramble Signals

¶ 2.15



The Millbrook Bread Cap:
Market price = $3.
Cap = $2.
Pavel's cost = $2.

The Result: Pavel earns nothing and bakes less. Rosa (who values bread at $5) finds empty shelves.

Takeaway: The price signal called for more bread; the cap created a shortage.

Willingness to Pay vs. Need



The Critique: Markets measure money, not need. A poor family may need bread more than a rich family wants cake, but lacks the funds.

The Defender's Reply: If the poor need resources, give them money directly. Do not scramble the price system itself. Both positions deserve a hearing.

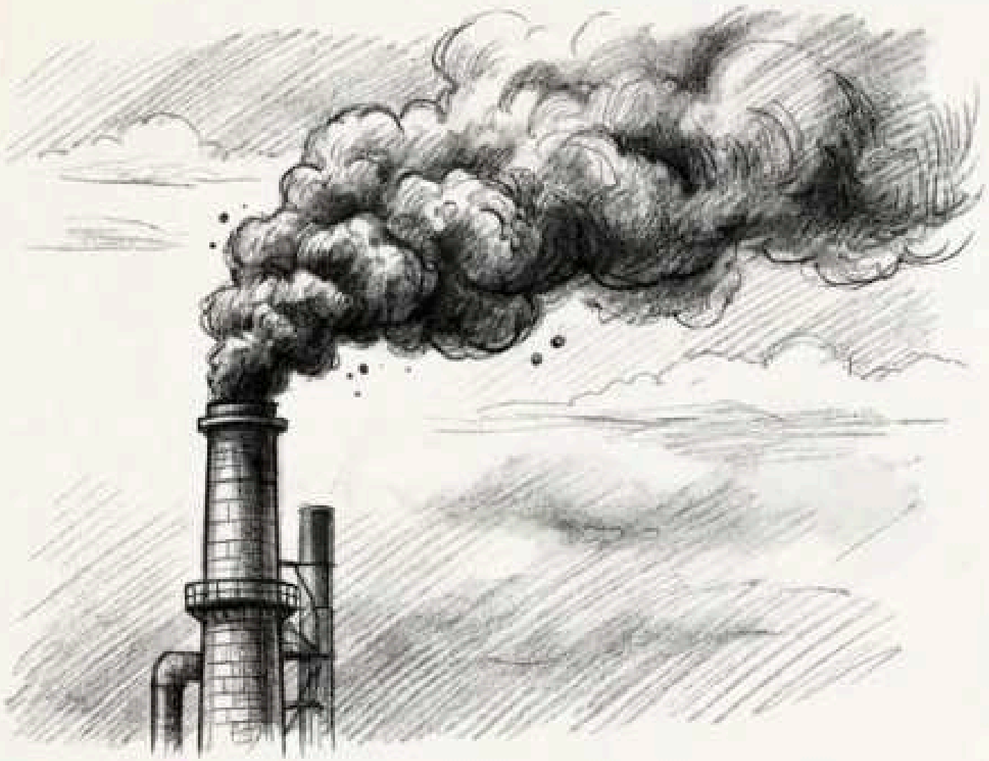
The Post-Storm Gouging Debate

Pro-Market: The $1000 price rations scarce generators to those who need them most and attracts new suppliers from afar.



Critics: A 100% price increase is "gouging" and is fundamentally unfair to those with little money during a crisis.

When Prices Mislead



Flaw 1: Prices ignore externalities (harms to others like pollution) and don't capture every cost.



Flaw 2: Prices carry collective mistakes (bubbles in housing or stocks when traders collectively misread signals).

Hayek's Defense: Prices are not perfect; they are simply the best available knowledge carriers.

The Pretence of Knowledge

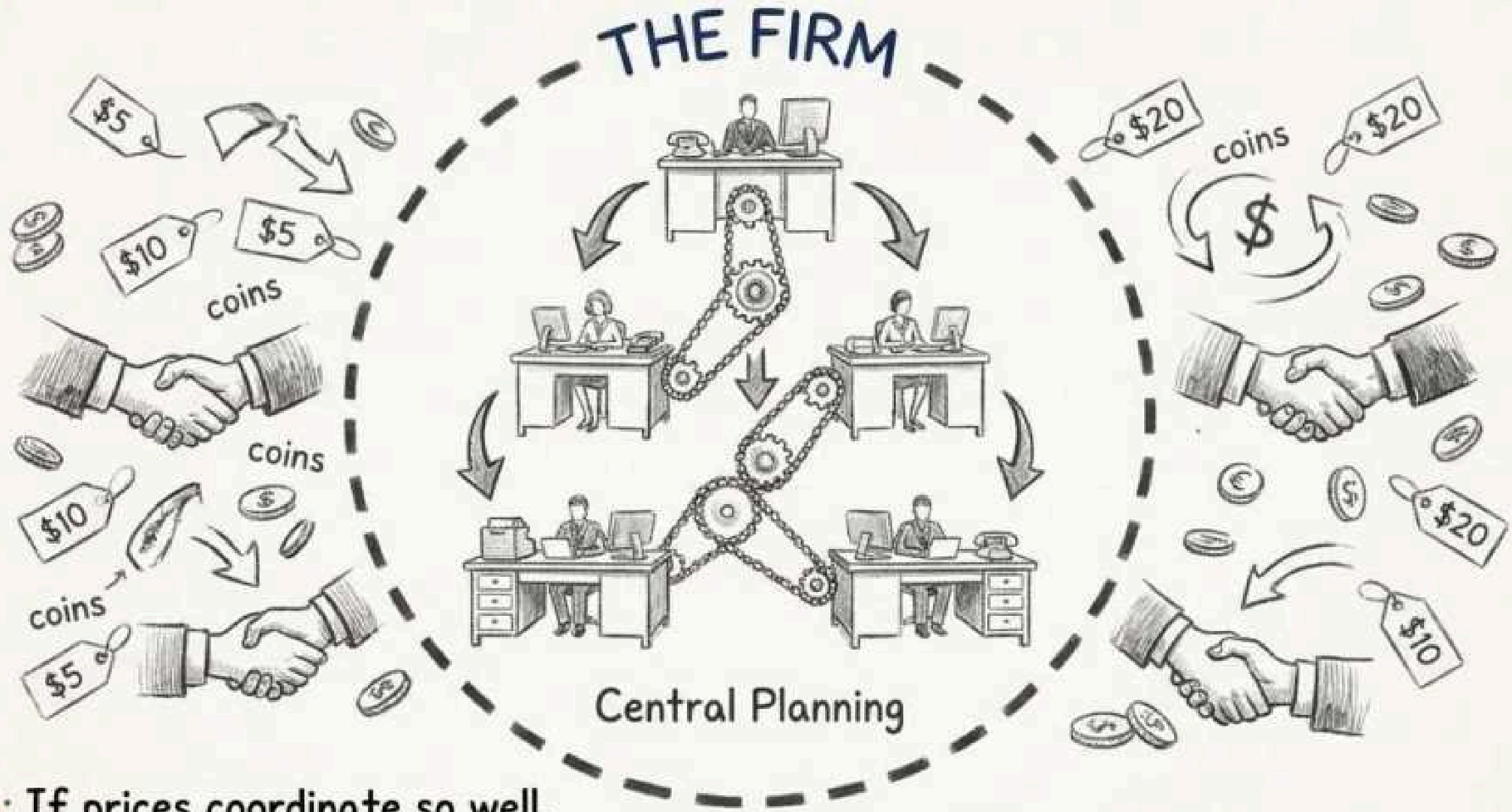
Hayek's 1974 Nobel Lecture



The Warning: Economists and officials know less than they think. Regulators fundamentally lack the local knowledge of the people they affect.

Counter-point: Defenders of regulation argue that some complex problems require rules regardless of knowledge gaps.

Ronald Coase and The Firm (1937)



The Question: If prices coordinate so well, why do firms exist?

The Answer: Using the market has transaction costs (searching, bargaining, enforcing contracts).

Takeaway: Free-market economies contain massive amounts of internal planning (firms). The boundary between firm and market is a choice.

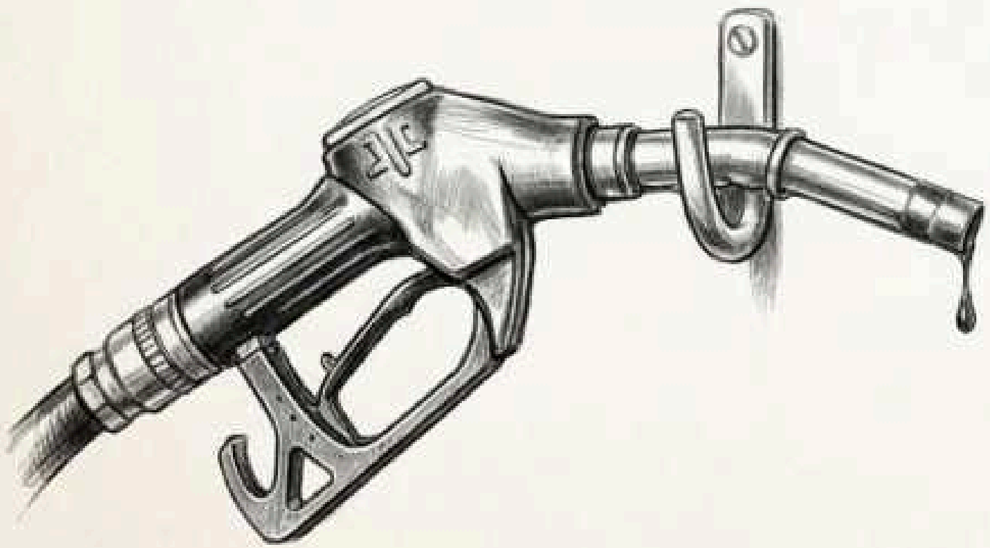
The Question for this Lecture

¶ 2.21

Think of a price that changed recently (petrol, rent, flights). What did that price tell you?

How did you respond to that signal?

What might have gone wrong if an official had tried to set that price instead?







Looking Ahead to Lecture 3

¶ 2.22



We have seen how **prices coordinate knowledge** and **reward value.** Next, we turn to:

- Property, profit, and the entrepreneur.

Closing thought: Who creates the new things that prices then reward?