The invisible hand

To understand how markets allocate the resources of a society it is helpful to introduce the concept of the invisible hand. In economics, the invisible hand, also known as the invisible hand of the market, is a term economists use to describe the self-regulating nature of the market. This metaphor was used by the economist Adam Smith in his work *The Theory of Moral Sentiments* (1759) and in many of his other works. Smith is often considered the father of economics, and his writings have been enormously influential.

Adam Smith defended the belief that every individual is interested only in his own security and his own gain but, when pursuing his own well-being, the individual usually promotes the well-being of society as if guided by an "invisible hand." According to Adam Smith, in a free market each participant will try to maximize self-interest, and the interaction of market participants, exchanging of goods and services, will make each participant better off than when simply producing for himself/herself. Each individual tries to become wealthy by being selfish and looking for his own gain, but he must exchange what he owns or produces with others who value what he has to offer. In this way, both buyers and sellers are better off and public interest is advanced.

For Smith, the "invisible hand" that organizes the economy is a result of the conjunction of the forces of self-interest, competition, and supply and demand. Smith also said that in a free market no regulation or government intervention is needed because this "invisible hand" guides market participants to trade in the most beneficial manner.

In one of Smith's most famous quotes:

*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.*

In other words, we get meat from the butcher, beer from the brewer and bread from the baker just because they decided to start a business and sell their products and not because they are benevolent or altruistic. But why did they start their businesses?
hey started their businesses because they wanted to make money and become wealthy and they saw the opportunity. They were selfish and wanted only their own gain.

People need to eat meat, drink beer and eat bread so there's a big demand for those products. And if there's a big demand, there are opportunities for businesses. If selling meat, beer and bread were not profitable, there wouldn't be any butchers, brewers or bakers.

Then we see that a market-based economy forces people to think about what other people want and that is extremely positive for the society. In other words, by being selfish, the butcher, the brewer and the baker help society because they provide what society needs.

The Role of Prices

Market prices play a crucial role in the economy because:

a) prices are signals that inform of excess demand or insufficient demand.
b) prices are signals that serve as an incentive to producers.

- For example: Imagine that the price of potatoes is very high. That means that potatoes are highly valued by consumers. At the same time, a high price is an incentive for producers to produce potatoes because now selling potatoes is very profitable. Now the producers might decide to grow potatoes instead of carrots. To produce more potatoes they will need to reallocate resources (land, labor, water, etc.) that were used to produce carrots.
- Another example: Imagine that the price of potatoes is very low. That means that potatoes are not valued by consumers. At the same time, a low price is an incentive for producers not to produce potatoes because now selling potatoes is less profitable. So they might decide to grow tomatoes instead of potatoes. To produce more tomatoes they will need to reallocate resources (land, labor, water, etc.) that were used to produce potatoes.

Through this process markets constantly allocate and reallocate resources from one industry to another.

The Market and the Three Fundamental Economic Questions

Remember that the industry tries to produce the goods that are most highly valued by consumers, so economic well-being increases. In this way, consumers are answering the first fundamental economic question (What to produce?): If there's a high demand for a particular product, that product will be produced by some entrepreneur or firm. On the contrary, if a particular product is not demanded, no entrepreneur or firm will produce it.

The competition between producers will answer the second fundamental economic question (How to produce?): The different firms compete against each other in a free market and only those who are able to minimize their costs will survive. Therefore, competition forces the firms to be efficient by dictating to them how to produce.

The third fundamental economic question (For whom to produce?) is answered by supply and demand in the markets for productive factors. Those markets determine
wages, interest and profits. Note that wages, interest and profits are the income that will be spent on buying goods and services.

1. What do you think the underlined words mean in the context of the text? Write an example sentence for each of those words using at least 15 words.

2. Invent a situation to exemplify Adam Smith’s invisible hand metaphor.

3. According to the text, why do you think government intervention in the economy might not be beneficial?