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ECON 202—Montgomery College

LECTURE 07: THE PRICE SYSTEM II

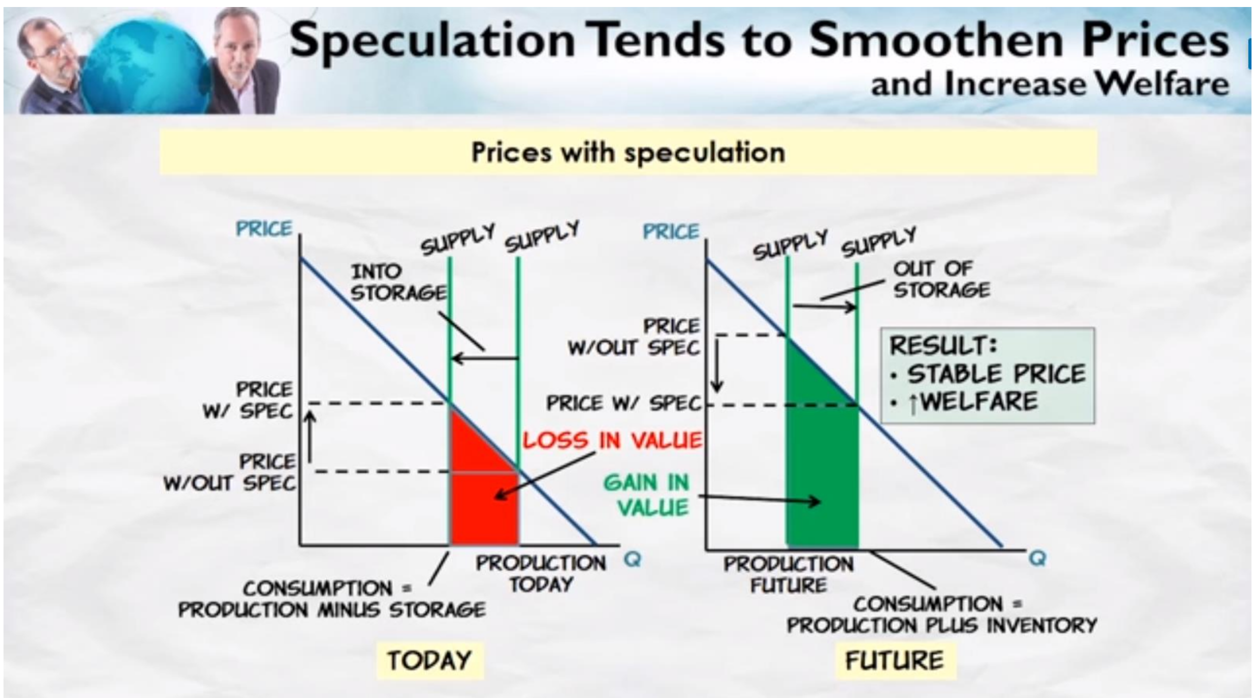
I. Emergent Order
   a. In general, economists rely on "the market" to solve the Great Economic Problem. Specifically, we rely on prices. Prices accomplish two big goals.
      i. *Prices convey information*. If the price of something is high, then we, a whole, know that that something is scarce. If it is low, then we know it is abundant.
      ii. *Prices induce action*. If the price of something is high, then people have an incentive to sell that something. If it is low, then they have an incentive to not produce it.
   b. Prices lead to *emergent order*—order without centralized plans. (Though markets are not the only manifestation of emergent order.)
      i. By "order" I mean a system with predictability and stability. Emergent order means a system can have these things without someone micromanaging the system.
      ii. In most circles people call emergent order "spontaneous order" but this is a bit of a misnomer—it is not instant, unplanned, or impulsive. It *emerges*.
   c. The recognition of this miracle dates back to Adam Smith. He called it *the invisible hand*—a metaphor describing that, when markets work well, people pursuing their self interest also pursue the social interest. The equilibrium is the optimum.

II. Complexity
   a. For any given resource, there are many uses of that resource and many alternative resources that could be used.
   b. Thus the emergent order of an economy—especially an advanced one—is incredibly complex. For every input, there are substitutes, and substitutes for those substitutes, and there are complements and substitutes for those complements.
   c. While we know how obvious connections will be affected (e.g. direct complements and substitutes), it's harder to know the size of the effect and even harder to predict the indirect consequences.
   d. But, crucially, we don't need to know. At every step, market participants follow the changing prices without knowing why prices

changed in that way. People move resources from low value places to high value places. An order emerges.

III. Speculation

a. This complexity isn't limited to space; it crosses time as well.
b. *Speculation* is attempting to profit from future price changes.
c. If people think the price of oil will increase in the future, they will buy oil now and sell that inventory when prices are high.
d. This results in price smoothing. If speculators buy when prices are low and sell when prices are high, then lower prices induce increasing inventories and higher price induce reducing inventories. The former increases low prices and the latter reduces high prices.
e. This is efficient, or welfare-enhancing. Low-value consumers don't use oil now but that allows high-value consumers to use oil later.



f. Here's a screenshot from a video at Marginal Revolution University to help illustrate the point. Full video available [here](https://www.mruniversity.com/courses/principles-economics-microeconomics/speculation-oil-futures-market).[1]

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