

Lecture 1 How Prices Develop in the Market Place

In lecture 1 we discussed how prices develop in the market place. In important works by Menger, Mises, and later Rothbard, it is explained that the starting point of Austrian Economics and of price theory is human action.

Every day people make choices about how best to spend their time and energy, with the aim of improving their situation. Improving means realising goals that have not been met yet. These goals can be anything, buying a new car, going on a holiday, making more money or enjoying more leisure. Human Action is about realising the most important goals or ends, by using the means available. By successfully doing so, people will improve their well-being, increase their welfare, in other words they will become more happy.

When people act, they have to make choices. Means as resources and time are limited or scarce, not all goals can be realised unfortunately. How do people choose? They choose by ranking their goals in order of importance. These preferences are subjective, meaning they differ from person to person and they change over time. Values and preferences belong to an individual person and cannot be compared to someone else's preferences. This also implies preferences and well-being cannot be measured.

A person will first seek to fulfil the most important need or preference, then the second, and so on. It is not the physical good properties that is important to people. It is the use value they attach to those goods and their services that matter. This use value is subjective. One person may appreciate a good very much, for another person the use value could be nothing. In economics the term utility is often used to describe the usefulness of goods and services, this term refers to the use value.

Every person values the possession of or command over 2 goods above 1 good, 3 goods above 2, and so on. The more units a person has of goods that are exactly the same, the better it is for this person. If a person adds a second good to their possession, the use value of this second good however is less than the use value the first good offered this person. This is called the law of diminishing marginal utility. How much a good is worth to someone depends on the use value of the last added unit of a good. The value of a good or service is hence determined by the use value the last added unit provides for. This is called the marginal utility.

In realising a higher ranked goal, a person will exchange a lower preference with a higher ranked preference. Say a person wants a horse and has a lot of fish, this person will be happy to exchange some fish with a horse from someone else. If another person has a few horses but no fish, they may transact with each other. Whether or not this happens depends on how much they value eating fish and how much they value using a horse.

This implies that in barter goods have use value and transaction value. Transacting and exchanging are the basis for a market economy and for co-operation in society. It is

driving the division of labour, each person focusing on what they are good at relatively speaking. Even if one person is superior to all other people in society, it still pays off to work and transact together.

When 2 people transact both will benefit: they value the good differently. The person selling fish values the a horse more than the fish and the person selling the horse values more the fish. When they have more fish and horses, they keep on transacting until for both the marginal utility of the good added is smaller than the marginal utility of the good sold. The price of a horse is then established as a certain number of fish. This example can be expanded by adding more buyers and by adding more sellers. The principle of people transacting remains the same. This process can be depicted graphically with the so-called supply- and demand schedules or curves.

With more people, there will be more competition. People will outbid each other until 1 or a few most capable buyers and sellers remain. The price on which they agree will count for the entire market. If this would not be the case, speculators who correctly see the mis-pricing will step in. The benefit of speculators is that the market equilibrium price will be reached more quickly.

Before a person can exchange, this person has to own a good. This is what 'Say's Law' is about. In a barter economy you cannot go to a market and expect to be able to buy something, without offering a good in exchange. This good has to be made or produced first, and with this supply a person is able to demand something else.

The marginal utility theory provides a proper explanation why the price of water is so much lower than that of diamonds, even though water is actually much more important for our existence. The supply of water is sufficiently abundant to meet almost all our needs. The price a consumer is willing to pay for the last additional unit is much lower than if the supply of water could only meet the most essential use, such as survival. In this way, the prices of goods and services that hold value for us are established.

Money is also an economic good and it provides a valuable service to its owner. Money developed in the marketplace as a good that has the most market-able product. Horse and fish are not very market-able, as it is difficult to vary them around and divide them in smaller pieces when needed. In the past gold and silver developed as the goods which best serves people in exchanging.

Money and prices do not measure value. Value can never be measured. With money it is easier though to compare prices. Money has a purchasing power depending on the prices of all the goods and services. In ranking people's preferences, they can now compare money and a certain good. People can prefer to hold on to a certain amount of money over and above purchasing this good. A person always values 101 euro above 100 euro etc. The more money a person has, the less value the last unit will provide this person. The law of diminishing utility also applies to money.

In ranking money and goods a theoretical problem occurs in explaining how money prices develop in a market economy. The demand schedules in a market economy depend on the demand schedules of all individuals added up. The individual demand schedules depends on the individuals' ranking of the good and money as given by all alternative uses. The alternative uses depend on the purchasing power of money and this depends on the existing prices of all goods. But, how can value scales be used to explain money prices, when these value scales depend on existing money prices? We seem to have a circular problem here.

Mises solves this problem with his Money Regression Theory. His solution was to explain that in order to rank money and goods money must *already* have a marginal utility. This marginal utility must be based on pre-existing prices of all the goods. Assume you want to theoretically explain how prices are being determined at the end of a certain day. The money price at the end of that day is determined by marginal utility of the good you want to purchase and by the marginal utility of money of beginning that day. The marginal utility of money at the beginning of a day is based on the existing series or array of prices then.

Put differently, the array of prices today depends on an array of prices yesterday. These depend on the prices the day before, etc., until the moment a money good was first used as money. In the case of gold this was the first day gold was used not for the direct use, but to exchange it with something else. The money prices that day depended on the prices the day before when exchanges just took place in a barter economy. In a barter economy with direct exchanges only, a time component of prices depending on the day before does not exist.

The Regression Theorem completed the theory of explaining how prices come about in a money market economy. People are prepared to offer the least important end of their preferences and to exchange this lower preference with a higher ranked goal, and vice versa. Expressed in prices, people are prepared to pay the highest price for those goods or services they attach the highest use value to, and vice versa.