What is the invisible hand?

Who organizes your breakfast when nobody is in charge? The division of labor and its limit, self-interest and exchange, the price that clears a market, the invisible hand, what Smith wrote and what he did not, where prices fail.

1 The person

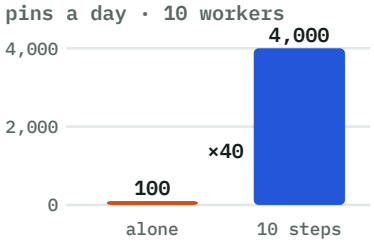
Adam Smith

- **Adam Smith** · Scottish · `1723–1790` · born Kirkcaldy, died Edinburgh · taught moral philosophy (right and wrong), University of Glasgow
- Books: The Theory of Moral Sentiments (**1759**) · The Wealth of Nations (**1776**)
- His question → what makes a nation richer? what holds a country's work together when **nobody is in charge**?

2 Division of labor

pins · its limit

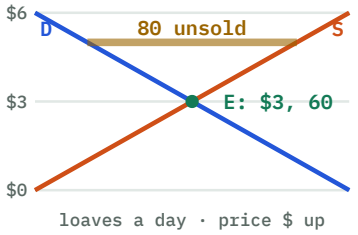
- **Division of labor** = job split into steps, a different worker (or machine) per step → skill grows, no time lost switching
- Coralia (toy island), 10 workers: whole pins alone `10 × 10 = 100` /day · 10 steps → **4,000** · `4,000 ÷ 100 = ×40`
- Smith (Book I, ch. 1): one worker alone "could not make twenty" · ten in steps "upwards of forty-eight thousand" → `48,000 ÷ 10 = 4,800` each
- **Limit** (Book I, ch. 3): "limited by the **extent of the market**" = how many buyers → a village needing 100 pins cannot keep 10 specialists busy
- Practice: nails, 6 workers × 15 = **90** → steps 1,800 (×20) · town buys 600 → **1,200** unsold



3 Price

self-interest · equilibrium

- Specialists must swap · Book I, ch. 2: "It is not from the **benevolence** [kindness] of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest"
- Bread on Coralia (`P` = price $ · `Qd` = loaves wanted · `Qs` = loaves baked): `Qd = 120 − 20P` · `Qs = 20P` · $5 → 20 wanted, 100 baked → **80 unsold** → bakers cut the price
- Too low → a queue → sellers raise it ⇒ **equilibrium price** (buyers want = sellers offer): **$3, 60 loaves** · nobody planned it
- Practice: fish `100 − 10P = 15P` → **$4, 60** · $6: 50 unsold · $2: 50 buyers without · umbrellas too cheap → queue → price up → queue gone



4 Invisible hand

once in the book

- **Invisible hand** = prices steer people who think of their own gain toward what others want · Book IV, ch. 2: the merchant "intends only his own gain" and is "led by an invisible hand to promote an end which was no part of his intention"
- Phrase: **once** in The Wealth of Nations · once in Moral Sentiments (1759, rich landowners) → never a slogan for Smith

5 His words

wrote it · did not

SMITH WROTE	ADDED LATER BY OTHERS
sellers of the same trade meet → "a conspiracy against the public, or in some contrivance [trick] to raise prices" (Book I, ch. 10) · **three duties** of the state (Book IV, ch. 9): defense · courts of justice · public works (roads, bridges) no private person would profit from	"**Greed is good**" → short form of Gordon Gekko's "greed, for lack of a better word, is good", film Wall Street (1987) · "**laissez-faire**" (French, "let it be": leave markets alone) → not in The Wealth of Nations · "the state should do nothing" → he gave it three jobs

6 Where it fails

so what?

- **Externality** = cost or benefit on people outside the deal → in nobody's price · cloth mill: smoke costs the village **$2**/meter · practice: tannery (leather) 200 hides (skins) × $3 = **$600**/day to fishers
- **Market failure** = prices left alone steer to the wrong amount (Microeconomics, Lesson 10)
- FOR prices let millions of strangers coordinate without a planner · AGAINST they miss outsiders' costs, and sellers can conspire
- **Timeline of ideas** · 1776 · Smith · prices coordinate strangers

Watch out: "invisible hand" ≠ "markets are always right": Smith used it once and named limits himself · the price moves because of unsold goods or queues, not kindness · more output from splitting needs enough buyers