



The Importance of Understanding the Market Process

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1. Introduction

Most students of economics today study the field from the perspective of the equilibrium analysis and tend to ignore the process through which markets allocate resources. While equilibrium analysis may have its place in economics, it is imperative for students to understand what the market process is, in the way it is explained by the members of the Austrian School of Economics. This means that we cannot have a full and clear understanding of resource allocation process without understating the market process as seen by Austrian economists. In the second section of this paper, I discuss two fundamental ideas from which we will derive the market process. In the third section, I discuss the differences between equilibrium analysis and the market process. In the fourth and fifth sections, I discuss the market process from two perspectives and conclude with a discussion about the proper role of government in the market.

2. Sheer Ignorance and Tacit Knowledgeable

We cannot have a complete understanding of the market process without first understanding what Israel M. Kirzner means with “utter ignorance” or “sheer ignorance.” Before we define “sheer ignorance” let us understand the view mainstream economists have on markets. According to mainstream microeconomists, markets work if they achieve rapid market clearing (reach equilibrium). According to this view, prices adjust immediately to changes in market conditions. In other words, when supply and/or demand changes so do prices, in order to reflect these changes



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that have occurred in the market. This implies that, according to mainstream microeconomics, the market is either at or close to equilibrium. Mainstream economists are aware, that market participants may be ignorant of certain market changes, and this may stop the market from reaching the equilibrium. They maintain, however, that this ignorance of changes in the market or of certain conditions in the market can be removed at a cost. All we need, mainstream microeconomists argue, is to consider that there are costs of information acquisition and, if those costs are taken into account, then markets will reach equilibrium.

On the other hand, Kirzner argues that the type of ignorance that keeps markets from reaching equilibrium cannot be eliminated at a cost. Kirzner (1992) argues that market participants are unaware of what knowledge related to the market they need to acquire. In other words, market participants do not know what they do not know. It is true that if market participants know what knowledge they are missing and, if they know that the benefit of this information is greater than the cost, this knowledge can and will be acquired. However, “sheer ignorance” relates to the knowledge that market participants are unaware they need to acquire, and as such, it cannot be eliminated simply by

incurring a certain cost. This type of knowledge is instead discovered in the market process. At a certain point, market participants will realize what they are unaware of and change their behavior accordingly. Consider for example the history of credit cards, that Randall Holcombe discusses in his book *Advanced Introduction to The Austrian School of Economics* (Holcombe, 2014, p. 5). When credit cards first came into existence, they were issued by specific stores and could only be used in those stores. Eventually, entrepreneurs realized that it would be beneficial to have credit cards that could be used nearly anywhere. Those who came up with credit cards at first were “utterly ignorant” of this opportunity. That is to say, not only did they not realize they could benefit more by having credit cards used in many places, they did not even realize they did not know this. Eventually entrepreneurs realized this, and in the process, they eliminated part of the sheer ignorance in this market.

In order to have a good understanding of the market process we must also understand the nature of the knowledge in the economy. Friedrich A. Hayek distinguishes between two types of knowledge in his paper “The Use of Knowledge in the Society.” He argues that one way to think about the knowledge in our world is to distinguish between “scientific knowledge” and “the knowledge of the particular circumstances of time and place.” Hayek recognizes the importance of scientific knowledge, but he emphasizes that it is “the knowledge of the particular circumstances of time and place” that is relevant in the process of resource allocation. Hayek provides different examples to illustrate this kind of knowledge: ranging from the arbitrageur who recognizes price differences in different locations to the real estate agent who mostly has knowledge of temporary opportunities. In both of these cases, the knowledge that these individuals possess is specific to the time and circumstances in which they find themselves. Alternatively, consider the individual

who came up with a credit card capable of being used in multiple locations. This knowledge only came into existence with this individual at that moment.

It is also important to recognize that “Individuals possess knowledge that not only does nobody else have but nobody else could have” (Holcombe, 2014, p. 7). This has important implications that we will discuss in section five, but for now, suffice to say that the knowledge that is relevant for the purpose of resource allocation is widely dispersed. Moreover, knowledge that people have often takes the shape of tacit knowledge, or “knowledge that they [people] are able to use but which they are not able to effectively communicate to others” (Holcombe, 2014, p. 7). As opposed to scientific knowledge, this type of knowledge is accumulated through life experiences and observation and cannot be easily transferred. Consider, for example, the reasons why CEOs might be paid high salaries. One may think this is because they are updated in the most recent scientific knowledge, but if scientific knowledge was what firms wanted, then they should hire recent MBA graduates. It is in fact the tacit knowledge that these CEOs have accumulated through the years that creates value for these firms, such that they are willing to pay these high salaries (Holcombe, 2014, p. 7). This does not mean that only CEOs can possess tacit knowledge. In fact, everyone in the society possesses some tacit knowledge (Hayek, 1937). Tacit knowledge is accumulated through experience, and as such, it is possessed by all level of business hierarchy, from entry-level jobs to CEOs as well as people outside of the business world.



3. Market Process vs Equilibrium Analysis

The foundation of economic analysis today is based on equilibrium analysis. Starting from introduction level to doctoral level economics classes, the supply and demand framework is at the center of economic analysis. In this analysis, students are taught that prices adjust in such a way that supply and demand equilibrate and that whenever the market is not in equilibrium these market forces pull it toward the equilibrium. Hence, this analysis concentrates on the outcome of the market process rather than the underlying forces that produce such an outcome. On the other hand, Austrian economists emphasize the market process by which markets always tend to move towards equilibrium. For Austrian economists, markets are never in equilibrium, since the world that we live in is continuously changing. This means that we should emphasize dynamic analysis in the market rather than the static analysis often used in microeconomics textbooks.

Austrian economists argue that preferences and the knowledge we have about how to conduct certain production processes change continuously. In addition to this, new products enter the market, market participants enter and exit markets continuously as well, so all of these and many other changes ensure that we never reach the equilibrium. Moreover, it is important to keep in mind that market participants act in the presence of sheer ignorance and that the knowledge necessary to reach equilibrium is widely dispersed among all market participants. Hence, it is unrealistic to expect that markets will reach equilibrium under these circumstances.

As we have discussed above, market participants are suspect to sheer ignorance, which means they do not know what they do not know. This ignorance then can be a factor that inhibits markets from reaching equilibrium. For example, in many markets, there are often local price differences for products or services. According to mainstream economics, this should not persist for very long as long as we account for the appropriate costs of acquiring information. Yet, mainstream economists assume that market participants are aware of these price differences and all that matters is that we account for the costs of information acquisition. The problem is that in the presence of sheer ignorance, individuals may not be aware of these price differences. If this is the case, then taking the cost of information acquisition into account, does not solve the problem these markets face, and these markets will continue to be away from the equilibrium. This will persist until enough market participants are made aware of these price differences and the sheer ignorance is eliminated in the market.

Additionally, the equilibrium is an ever-changing target. As available information in the market changes, so does equilibrium. Let us consider an example to illustrate such a situation. Consider a situation in which we have a series of



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research papers claiming that eating red meat can cause heart and blood pressure problems. In such a situation, one would expect people to start switching from red meat to other sources of protein such as fish and chicken. As people switch to fish and chicken, we would expect the demand for these products to increase and consequently there would be a higher equilibrium price (holding the supply constant). If nothing changed, from this point on, one may expect the price of chicken and fish to move toward the new equilibrium and even get very close to it. Yet, as we have argued above, the continuous change, that is ever-present in our world will ensure that the equilibrium point continues to change and we may never reach it.

Entrepreneurs, “watching” this situation realize that there is a profit to be made if they can offer those who prefer red meat a product that is similar to red meat but does not bring the negative health consequences mentioned above. Companies like Beyond Meat start producing and offering this product to consumers. Now we have a new alternative to chicken and fish. This change in the market will slow down the demand for these products and change the equilibrium point. It is important to understand that the example presented here is simplified. The discovery of “fake meat” is not the only new change that occurred in this market since the new research on red meat was published. Maybe during this same period,

there is a growing concern on how chickens are raised or about humans fishing too much. Both of these would lead to a lower demand and a change in the equilibrium point in these markets. But we need not stop here. Imagine that during this time, there is new research showing that plant-based diets are superior and more people start changing their diet. Alternatively, imagine that there is an increase in the price of poultry feed. All of these changes and countless others, that we can neither know nor imagine at any point in time, continuously change the equilibrium point. This means that markets, rarely if ever reach the equilibrium point.

If markets rarely reach equilibrium, then what we should focus on is the process by which markets allocate resources and how economic coordination happens. We should focus on understanding how and why these changes arise in an economy. It is also equally important to study the conditions that allow and incentivize market participants to be able to adjust and adapt to market conditions so that resource allocation is efficient. What we described above with the series of changes in the economy is, in fact, part of the analysis that we should concentrate on and try to understand. We will discuss the market process further in the next two sections below, but before we move to the next section it is important to mention that what we have discussed in this section does not mean that equilibrium analysis is useless and should not be used. Equilibrium analysis is helpful especially as far as introducing students of economics to how markets work in isolation before we introduce the whole market process. Isolating and analyzing market changes one by one allows students to understand how each of these changes by themselves affects the market. Once students have this knowledge, we can then introduce the market process and broaden the understanding of the market process. Unfortunately, today most textbooks only focus on static equilibrium analysis and ignore the market process through which resource allocation happens. In what follows I discuss the market process from two different perspectives.



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4.

Market Process as a Discovery Process

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One way to think of the market process is as the discovery process through which sheer ignorance is eliminated. Kirzner argues that, “Markets work by providing incentives for the discovery of overlooked opportunities for mutually gainful exchanges” (Kirzner, 1990). Entrepreneurs are constantly looking for opportunities of how they can transform the existing resources into products and services that enough people will prefer and purchase. These entrepreneurs are incentivized by the profit motive (or avoidance of loss), which pushes them to always keep searching for ways to improve their products or come up with new improved products. In this sense, we can argue that “the market process is one of entrepreneurial discovery in the face of sheer ignorance” (Coyne and Boettke, 2020, p. 26).

Consider Holcombe's example from above regarding to credit cards. For a few decades, merchants only issued credit cards that could only be used in their stores. We can argue that all market participants were completely ignorant of the opportunity to earn pure profits by producing credit cards that could be used in multiple locations.¹ Yet, eventually, motivated by the profit motive, someone figured out that this would be a great opportunity. What is important to understand here is that while we are in the presence of sheer ignorance, no one can know with certainty when sheer ignorance will be eliminated. However, we can say that any time that a market participant or market participants discover something that no one was aware of, is a moment in which sheer ignorance is eliminated, and we move closer towards the equilibrium. We must realize that while these "Eureka" moments help remove some of the sheer ignorance, we will never be able to completely eliminate it. The world we live in is complex and ever changing, and as such, it is not possible for anyone to be fully aware of what is needed in given market. Lastly, even if such a thing were possible, it would not last for very long since market conditions change continuously.

¹ Pure profit here means profits that are beyond the opportunity cost of the investment. In other words, the profits here are better than in the next best opportunity.

5.

Market Process as a Coordination Process

We can also see the role of the market as a coordinating process. As we have argued above the information necessary for efficient allocation of resources is widely dispersed. Yet, we are able to make use of this information with the help of the market process and the price system. Any changes that occur in the market process will affect prices, and these changes in turn will lead to further changes in the actions of the market participants. Consider for example the situation we discussed above about the red meat market. Once negative research is published about red meat there will be a tendency for prices to decrease, and this in turn will send a signal to the farmers that red meat is less valuable and that they should start adjusting. These farmers then will likely start producing less red meat. On the other hand, this same research would have an upward effect on the price red meat substitutes. Thus, chicken farmers will receive the signal to start producing more chicken as a response to the increased consumer demand. As chicken farmers start producing more chicken, imagine that consumer preferences change in favor of vegetarian diets and away from chicken. This will lead to a lower demand for chicken, and as a consequence put downward pressure on price, which will send the signal to chicken producers that chicken is not as highly valued as before. Hence, changes in the market are reflected in the price system and this allows the market participants to act accordingly while taking into consideration the information “of the particular circumstances of time and place” that is incorporated in prices.

The importance of the price system in the market process cannot be overstated. Consider for a moment a family of four living on an island. In this case, the family will need to prepare so that they can get the most out of their labor. Maybe the father will hunt; the mother may gather fruits; one of the children may go out to gather



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firewood, and the other child may be in charge of bringing water. In this case, the family knows the strengths (comparative advantage) of each family member, so this should not be very difficult. Now consider an economy with millions of people and countless resources available. In this economy, it would be impossible for anyone to allocate all the labor and resources to the most valued uses given how widely dispersed the relevant information is.

To understand how the price system helps us achieve economic coordination, let us consider an example here and contrast the solution that would be provided by the price system with that of a command economy. Suppose we need to build a railroad to connect two cities. The problem we face is that a mountain chain separates the two cities, and we need to decide how to deal with this situation. To simplify the problem we will only consider two routes. Route one is to go through the mountains, and since this is a difficult endeavor, we will say it needs more engineers. Route two, is to go around the mountains, but since this is longer it will require more steel. The question we need to address is which of the two routes has the lowest cost of production for the society?

First, we will consider how we would make the choice under a command economy in the absence of prices. In this case, the central planner will consider both options and aim to choose the

one that provides the most value for the society. If the central planner chooses route one, then more engineers are needed, and engineers will be reallocated away from their current positions. On the other hand, route two requires more steel, which means that steel will be reallocated from its current uses. The central planner must consider the value of engineers and steel in their alternative uses. In the absence of prices, the central planner may try to survey all of the steel users as well as all of those who want to employ engineers and ask for the value they place in steel or engineers. However, this process not only would be extremely difficult and expensive to complete, but it would also be impossible to capture the real value of steel and engineers through simple surveys. Since these are surveys, one cannot be sure that the reported value is accurate.² Therefore, the central planner will find it impossible, to choose the optimal route.

On the other hand, in a market economy with prices, this answer is much easier. The railroad builder in this case needs only to look at the price of steel and the salaries of engineers and use these to estimate the cost of each option. He may then choose the option with the lowest cost. Keep in mind that prices reflect how urgently a product or service is needed, so in this case, we do not need to survey all steel users and all of the employers of engineers to find out which of the two is more urgently needed in other uses. Therefore, by choosing the option with the lowest cost, the railroad builder has ensured that he has taken into account, all the specialized information around the country about the urgency of the alternative uses of steel and engineers. This will ensure that we use our scarce resources to fulfill the most valued needs, and consequently benefit the most from our limited resources. Hence, this is how the market process through the price system helps coordinate the resource allocation process.

² This at best would capture people's wants but we want to capture the quantity demanded. Keep in mind that a want is a desire to have a unit of good or service, while to demand a unit of good or a service it means that one is willing and able to pay a given price at a given time. Hence, in this latter case people reveal to us the value by showing how much they are willing and able to pay.

6.

Market Process and Economic Policy

It is the understanding of the market process that leads Austrian economists to argue in favor of economic freedom. In the presence of sheer ignorance and widely dispersed information, a free market is necessary, Austrian economists argue, for voluntary exchange and social cooperation under the division of labor to function properly. The free market provides people with incentives, to make profitable discoveries, which are vital for proper functioning of an economy. Kirzner argues that the free market “is able to harness individual freedom to generate the systematic discovery process which is the basis for the coordinative properties of the market” (Kirzner, 1992, p. 54). Hence, the further away we move from the free market the harder it becomes for the resource allocation to happen via the voluntary exchange that captures the relevant market information.



Friedrich August Hayek

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When the government interferes in the market through regulations, taxes, subsidies etc., it prevents the elimination of sheer ignorance and it inhibits the coordination that occurs in the market through the market process. What is more, the more government interferes in the market the harder it is for individuals who have discovered an opportunity in the market to act. This is what led Hayek to say:



...the more the state ‘plans,’ the more difficult planning becomes for the individual

(Hayek, 1944, p. 114).

Government interference distorts market signals and as such makes it harder for individuals to use prices to adjust their actions. These distortions also prevent market participants from responding to the discoveries they may have made accordingly and lead to a persistence of sheer ignorance in the market.

One such example of government interference is the case of occupational licensing. These licensing requirements greatly increase the cost of entry for new market participants, and as such, prevent them from entering the market. Consider a case in which a young man who has a talent for cutting hair and he realizes that there is need for his services in the neighborhood where he lives. This young man has already accumulated some experience cutting hair for his family and friends and everyone likes his work and thinks he is quite talented. Yet, if he wants to open a barbershop, he needs to first obtain a license. This will cost him both money and time that he may not have, and it may make it impossible to enter this market. This is how government regulations can harm the market by interfering with the market process, and inhibit the process of sheer ignorance elimination. In this case, the young man realizes a need in the market that he can fulfill, but he will not be able to do so because of the high cost of entry in this market. Hence, the discovery that the young man made will not affect the market and the sheer ignorance in this market will persist and consumer needs go unfulfilled.

Let us consider another way through which government intervention that disrupts the market process. Many countries have anti-gauging laws that aim to limit how much prices can increase in a given period of time. Lawmakers argue that these laws are needed to protect the consumer from greedy businesspeople. However, what these lawmakers and those who support these laws do not understand is that prices act as signals indicating the relative scarcity of products. Take, for example, the situation many people found themselves in early 2020, in the United States as COVID-19 was spreading fast. As demand for masks and hand sanitizers skyrocketed, many stores could not adjust prices to meet the higher demand because



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of fear of prosecution. This led to widespread shortages of many items. Price increases in this case would signal increased relative scarcity in the market for these items. This would send a signal to consumers to ration and purchase fewer of these items, and it would send a strong signal to producers to produce more. Since, prices were not allowed to increase the coordination process was interrupted, and shortages persisted for much longer than they would have in the absence of anti-gouging price laws.

What we have seen here through these two examples is that government inhibits the market process through its intervention, and consequently it inhibits efficient allocation of scarce resources. This interference in the market will lead to lower production of goods and services, which will harm the welfare of the individuals who are affected (either directly or indirectly) from the government interference. This is why the “state should confine itself to establishing rules applying to general types of situations and should allow the individuals freedom in everything which depends on the circumstances of time and place, because only the individuals concerned in each instance can fully know these circumstances and adapt their actions to them” (Hayek, 1944, p. 114). Given what we have discussed in this paper, we will argue that only this limited role of government can be compatible with the proper functioning of the market process. Any further interventions from the government will inhibit the market process and the efficient allocation of resources.

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