

***The Poverty of Nations: A Sustainable Solution* (Crossway, 2013)
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Chapter Five “The Mechanics of the System”

Question: *How does a free market work?*

Introductory comment: No human being ever established a free market.

It is just how human beings act when they are together in communities – they seek mutual gains from voluntary exchanges. The government just has to get out of the way, but also punish crimes (rule of law – see chaps. 4, 6).

→ We should be thankful to God for this amazing human process, just as we are thankful for the beauty of the natural world.

A. No one decides what, how, and for whom a national economy will produce.

1. Milton Friedman (Nobel prize in economics): In free market, who decides what is produced?

Answer: → No one.

2. The economic knowledge necessary to produce any product is widely dispersed (even for the parts of a pencil: availability of materials, manufacturing processes, quantity that will be needed, how many people must work on product, for how long, etc.).

Nobody can travel around world and know first-hand all of what must be known. So how do things get made?
-- nobody in world knew that I would go to Home Depot to buy leather work gloves 12-7-13, 2:30 PM.

3. → People seem to be guided by an “invisible hand” – led to grow, mine, refine, supply, manufacture what is needed.
Adam Smith: “As every individual . . . neither intends to promote the public interest, nor knows how much he is promoting it . . . by directing [his work] in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by *an invisible hand* to promote an end which was no part of his intention. . . . By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.” (*Wealth of Nations*, book 4, chap. 2, p. 485).

4. Spontaneous human creativity that makes useful things in free market → “invisible hand” is evidence of God’s amazingly wise creation. (how he made us to function). Note examples of human creativity to serve needs of others:

a. Garments made & sold by godly wife (Prov. 31:24), Jesus as carpenter (Mark 6:3).

b. Tentmakers: Aquila, Priscilla, and apostle Paul (Acts 18:3).

c. The general command to work honestly with one’s hands (Eph 4:28)

5. Now, more details on how free market functions, why it works to produce what is needed & wanted:

B. Specialization and trade – the key to greater prosperity

[this process should amaze us, cause thanksgiving to God]

1. The problem: how can people in poor countries, who already work very hard, produce more goods of greater value while working same # of hours?

→ Specialization increases productivity and innovation, allowing more to be done in less time.

Adam Smith, famous example of pin factory (p. 168)

Pin workers then “traded” – got money, bought food from farmers, also clothing, other goods

Everybody in modern economy specializes and trades. (farmers = only 2% of population)

→ And every poor nation must do this (first internally, then also for export)

2. Specialization allows for *comparative advantage* and trade, which benefits everyone.

a. *Comparative advantage* always works -- even when one has *absolute advantage*.

b. Example - a doctor who can type twice as fast as his typist.

i. The doctor earns \$100 per hour, the typist \$15.

ii. The doctor doing it in half the time (4 hours = \$400) is more expensive than the typist (8 hours = \$120).

iii. The *comparative advantage* is in favor of the doctor practicing medicine and hiring a typist.

iv. This reveals the effectiveness of specialization and trading (selling), thus benefitting all.

c. A poor nation will always have a *comparative advantage* in making some products.

This keeps happening: China with small manufactured goods, Asian countries w/ textiles, Latin American countries with food crops.

3. Specialization in a nation changes over time.

a. General movement: Agriculture → Simple manufacturing → Complex manufacturing → services/consumer goods
→ information technologies

b. When poor countries move to more complex products, more developed countries have to improve or change to producing something else (ex: Japan after World War II - from simple manufacturing to cars, electronics)

c. Then where will displaced people find new jobs? → new products, new services (173 – exx in last 100 years)
World will never run out of new products and opps. - humans have limited needs but *unlimited wants*.

- c. Providing for the *unlimited wants* of mankind happens spontaneously in free-market systems
- i. In communist or socialist economies – seldom, and not done well (unless some free market allowed)
 - ii. *Unlimited wants* implies in a competitive free market there will always be jobs for those who want them. (unless government interferes by preventing new businesses from starting, prospering) [ex: Uber]
- C. **The free market has a remarkable signaling system.**
[this process should amaze us, cause thanksgiving to God]
1. Free markets spontaneously signal to workers what jobs need to be done, and to businesses what products need to be made. (no government planner says “go to this job” or “make this many pairs of gloves”) (amazing: p. 174)
 2. Result: 60,000 items in hardware/ building supply store, 45,000 unique items in large grocery store.
 - they just show up on time, in quantity needed!!
 - a. If a surplus arises, prices must ↓ and buyers → order less next week. The market adjusts.
 - b. If shortage, prices ↑ and buyers order more, producers make more. The market adjusts.
 - don't worry about predicted future shortages of this or that.
- D. **Prices are the language of the signaling system -- amazing worldwide source of instant economic information.**
[this process should amaze us, cause thanksgiving to God]
1. Supply and demand are never constant and prices signal how to respond.
 2. The price system is the only reliable and efficient means by which someone can track a market's complexity.
 3. Prices communicate objective information on the subjective attitudes and feelings of buyers and sellers.
 - Poor countries must not control prices, or else signals will not work.
- E. **Profits and losses are the green and red lights of the system, by which customers signal 'go' or 'stop.'**
[this process should amaze us, cause thanksgiving to God]
1. Profits are the incentive for improvements in products and services already present. (cars, TVs, phones) and the incentive for developing new products and the reward for successful innovation, meeting people's needs & wants
 2. Losses work to purify an economy of what consumers do not want. They signal producers to change, improve, or fail.
 - poor nations must not squelch profits & losses by excessive taxation of profits or bailouts to prevent companies from failing
- F. **Competition leads to interpersonal cooperation, better products, more choices, and lower prices.**
[this process should amaze us, cause thanksgiving to God]
1. Competition and cooperation naturally occur together and reinforce each other.
 2. Market competition is the father of innovation and a constant force for making progress happen.
 - a. Example - Palm Pilot, to Blackberry, to iPhone, to Android, to new iPhone 5, to
 3. Competition encourages and requires cooperation. (!!!) (yes)
 - a. Much cooperation required to develop & manufacture & sell iPhone – or woven baskets in poor country
 4. Progress and improvement naturally occur when competition and cooperation work together.
 5. The customer ultimately benefits from competition – more choices, better products, lower prices
 - a. A customer searches for what is best and cheapest, a producer how to lower costs and increase attractiveness.
 - b. Consumer choice signals to producers regarding price, as well as service and product quality.
 - poor nations must not stifle competition by protecting monopolies, or restrictive licensing of businesses
- G. **Entrepreneurship: many try, few succeed, but all of society benefits.**
[this process should amaze us, cause thanksgiving to God]
1. Free markets require innovation, which requires new ideas and new money. And a lot of work. And taking risks. Thus the entrepreneur fulfills a very significant function.
 2. Entrepreneurship involves 'creative destruction' of old, outdated businesses are replaced by newer, better.
 - a. This process overall benefits society as a whole.
 - b. Entrepreneurs in a competitive market soon rush to put new inventions at disposal of all mankind.
 - c. But not all benefit: “Creative destruction” is always moving those on top down, even out, if products not as good. The good news: due to unlimited human wants, new opportunities will always arise.
 - d. Those most affected by change in a dynamic economy will often seek laws protecting them from change.
 - i. Example: taxi companies & unions opposing Uber private ride service
 - ii. But opposition to entrepreneurs inhibits a society from needed change and innovation for new wealth.
 - poor nations should not hinder or restrict or penalize entrepreneurs
- H. **Summary of how a free-market system functions.**
1. Chap. 4: Foundations : 1) Private ownership of property, 2) Rule of law, 3) Stable currency, 4) Low taxes
 2. Chap. 5: Key Components: 1) Decentralized decision making, 2) Specialization and trade, 3) Signaling system of the market, 4) Prices as the language of signaling system, 5) Profits and losses as indicators of success/failure, 6) Competition and voluntary cooperation as the interpersonal dimension, 7) Risk-taking of entrepreneurs (innovation)
- And all of this “just happens”: Are we amazed? Do we thank God for this system?

- I. **How wealthy people in rich nations can genuinely help poor nations.**
 1. The only permanent solution to poverty is increasing a nation's GDP by producing of more goods and services of value. (chaps. 1-2)
 2. The only economic system that can do this is a free-market system. (chaps. 3-4-5)
 3. Therefore what practical steps can a wealthy person (or church) take to further promote free-market system and promote increase in GDP?
 - a. Investment in for-profit businesses, especially in nations moving towards a free-market and the rule of law.
 - i. The only way to know if a product is benefitting is through the signaling system of profit.
 - ii. When a product is truly making a profit in a poor county it helps the nation in 3 ways
 1. Making products that increase GDP.
 2. Making products that meet people's needs.
 3. Providing jobs that enable poor people to support themselves.
 - iii. Investment in a business that makes profit treats people with dignity, is not paternalism.
 - iv. Many promote micro-loans to single person businesses, but investment in small and medium enterprises (\$25,000-\$1 million) are necessary as well for larger economic growth.
 - b. Other ways to help
 - i. Supporting educational programs in poor countries that promote free-markets and the necessary governmental policies and cultural beliefs.
 - ii. Distributing literature that promote the same policies.
 - iii. Supporting seminaries in poor countries that also train pastors in appropriate cultural beliefs and values (outlined in chapter 9).
 - iv. Financial-assistance programs allowing future leaders in poor countries to study abroad in institutions that promote free-market economies, sound government policies, and beneficial cultural beliefs.
 4. Then what about giving to charitable organizations that meet short-term needs, especially in crisis situations?
 - a. This is also good: meets immediate needs.
 - b. Beware however of giving that promotes dependency rather than productivity.
 - c. Such direct gifts, however, will not bring about a permanent solution.

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<http://www.christianessentialsbc.com>.

See also waynegrudem.com