# Adam Smith's theory of invisible hand

In late eighteenth century, Adam Smith came out with an analysis of market trends of production and consumption, wherein he concluded that the markets, if left alone, have an inherent potential of becoming efficient. It is as if there was an invisible hand that guides the market to a level that is good for society. His theory has remained the cornerstone of all economics, even after two hundred years.

## The invisible hand

Adam Smith, in late eighteenth century, proposed a theory that stated that in a free and unregulated market, where anybody can become a producer or a consumer, people's demand of different goods and their production of the same good will be equal, and the allocation of their resources for production and consumption of different goods will be optimal for the welfare of the society. Put another way, Mr. Smith suggested that the invisible hand of market forces of demand and supply will achieve the most efficient level of production, consumption and distribution of goods in the society.

The idea of an invisible hand guiding the market to the best social outcome created a very strong reason in favor of free markets, and has been the standard argument against governments controlling production or consumption in any form that interferes with the free market.

## An argument for economic freedom

The invisible hand theory is the economic counterpart of democratic theory.

Just like in a democracy, where people are supposed to be capable of choosing the best leaders for themselves, the invisible hand theory presumes that the people will chose to produce and consume in the most efficient manner when given a free hand. Like politics, 'adequate information' is an essential ingredient for a free market as well, and like politics, inadequate information about prices, quality and suppliers can result in a less than efficient market. Similarly, like democracy, inadequate competition can defeat the process of market efficiency - as happens in case of monopolies.

So in practice, markets may still end up being less than efficient, but that is not because the invisible hand theory of free markets is inaccurate. Markets fail because of different factors, but more often than not they still provide the best option for achieving an efficient system of human economic activity.

## The demand and supply

In the invisible hand theory of Adam Smith, the two crucial concepts are those of demand and supply. 'Demand' refers to the willingness of people to pay a price for a particular good. If 100 people are willing to pay $ 10 or more for an object, the demand for that object, at a price of $

10, would be 100. Out of these, if only 50 are willing to pay $ 20 or more for the same object, then the demand of that object at a price of $20 would be 50. At a price of $30, the corresponding demand may be 20 only.

Now, if the cost of production of this article is $ 8, and the market price of that article is $30, then there would be a profit margin of $22, which will attract more producers to the market. When they also start production, the supply will be more, and the competition among the producers will bring the market price down, so as to bring it to $ 20, at which level, there will be more demand and so all that is produced will be consumed. If new producers continue to enter the market, the price may fall to $ 10, when there would be 100 buyers and all the 100 units of the object produced will be consumed.

Thus, when the demand is more, the market price of a good rises, thereby making it attractive for more producers to start producing. The entry of new producers increases the supply, and in turn reduces the prices. This continuous adjustment of market prices by addition or exit of new producers is the basic mechanism by which the invisible hand of the free market operates.

What was given by Adam Smith as a theory has now become the basic pillar of all economic decision making. It is true that the markets can also fail, as happens in the case of information asymmetries between the consumers and the producers, or in case of monopolies or public goods.