May 6, 2005

Fish and Hares

> My thought of the day:
> "Fish and hares: in the market there is no such thing as intrinsic value, only exchange value."

Suppose you take a lump of gold to a dealer and ask him what its value is. The dealer will weigh and assay the gold and make you an offer of, say, $1000. You tell the dealer that you will think about it and return the next day to sell the lump but the dealer is only willing to give you $990 today. What has changed? The intrinsic value of lump of gold has not changed overnight, it doesn't rot like tomatoes or tarnish like iron so why the change in price? If people were buying and selling things for their intrinsic value then the price of gold should not have changed because it is, atomically, the same as before.

To understand value we have to find out how value is created. When Joe is self sufficient to the point that he neither buys, sells or trades anything, the only estimation of value is how much satisfaction (utility) the thing will give Joe. Should Joe go fishing or hunting? The choice is made by some internal decision making process that we cannot fully quantify but it has something to do with the utility of the process to Joe. Joe nets 12 fish and on the way back home he meets Jack who has caught 3 hares. Talking they decide to trade three fish for one hare. Now we know what a fish is worth: one third of a hare. We also know what hares are worth: three fish each. After the fish and the hares have been consumed in a delicious diner, we no longer know the value of hares or fish until they are traded again.

Let's suppose that Jack only catches one hare the next day while Joe nets 100 fish in an extraordinary fishing exploit. On the way home they meet and Joe wants to trade three fish for one hare. Since Jack has only one hare, he is not willing to part with it so easily. He might settle for 30 fish. The food value of fish and hares has not change overnight. All that has changed was their availability. Today one hare is worth 30 fish and one fish is worth one thirtieth of a hare.

From the above example we can see that price comes about through exchange and it is not based on the supposed "intrinsic value" of things but only on their availability and utility to the buyers and sellers.

Economics is not a very exact science in the same sense that physics and mathematics are and this made economists unhappy. They wanted to be able to prove things economic just as exactly as physicists prove physical laws. But this can be done only if things have fixed or knowable qualities in fixed or knowable quantities. The mythical "intrinsic value" is one of these figments of the classical economist's imagination. How does this process come about? An experienced investor might say something like: "The fair value of an investment is the present value of the cash flow it produces over its lifetime." This sounds very precise until you try to find out some of the factors that you need to make the calculation. If you are buying a company you have to determine the cash flow it will throw off. There is simply no accurate way of doing that. The company might or might not produce certain quantities of goods or services and there is no way to tell what these goods and services will fetch on the market. Also, what discount rate should you use in your calculation? You either use today's rate or you make an educated guess about what the rate might be over the life of the cash flow.

In the effort to convert economics into an exact science economist have come up with all these incredibly inexact procedures to produce exactness. Somewhere along the line they forgot that a chain is as weak as its weakest link. Forecasting production, demand and interest rates exactly over the long run is an exercise in futility. Yet this is what the calculation of "intrinsic value" requires.

The only value we can measure with accuracy is exchange value. Yesterday hares cost three fish each and today they cost 30 fish each. BTW, we can't know the value of fish except in terms of hares unless we barter in some other commodities as well. When bartering becomes too complex we invent money which is just one more commodity that we have elevated to the rank of "money." Since money is a commodity like any other, its value fluctuates just like every other commodity's value does. Once we realize this we also realize that there are no fixed prices or fixed values, only comparative prices or exchange values.

By this time some readers should have caught the "fact" that I'm mixing price with value. If we cannot measure intrinsic value and all we can do is to know the "exchange value," a.k.a. "price" of things, then maybe we should stop talking about value and start talking about price only.

Denny Schlesinger
Caracas - Venezuela
denny@softwaretimes.com