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Man on the Spot

Hayek begins *The Use of Knowledge in Society*, his treatise published in The American Economic Review in September 1945, with the idea that the problem we try to solve when constructing a rational economic order is not a problem of optimal allocation of available means, but an issue of application of complete information not being given to any designated individual. The design of an efficient economic system relies on the principle that a central authority makes decisions to allocate available resources – and does so with all the relevant and available knowledge. In practice, this is gibberish. If a central authority could make optimal decisions to allocate scarce resources – having been bestowed with complete knowledge – implied volatility would seem to be a futile metric, or at the least cease to be extreme. High volatility would imply large swings in price, resulting from unpredictable changes. But if a central authority is making optimal decisions to allocate scarce resources with complete knowledge, the price of an option or security is always at its fair value, and could never to be undervalued or overvalued. We know this not to be true, because certain individuals in precise moments exercise applicable knowledge that is not available en mass – a man on the spot – whose special knowledge of circumstances presents him an opportunity to become, as Hayek explains, “an arbitrageur,” who can take advantage of local differences in commodity prices.

If the design of an efficient economic system is to succeed it must heed the importance of individuals who have expertise in relevant market circumstances, to make decisions in that time and place, that benefit market equilibrium. The problem of proper allocation of resources thus dictates decentralization, as no single central authority has all complete relevant information.