The paradox of value: why is water cheap and diamonds are expensive? - Video transcript

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00:00 Imagine you're on a game show, and you can choose between two prizes: a diamond or a bottle of water. It's an easy choice. The diamonds are clearly more valuable.

00:20 Now imagine being given the same choice again, only this time, you're not on a game show, but dehydrated in the desert after wandering for days. Do you choose differently?

00:28 Why? Aren't diamonds still more valuable? This is the **paradox of value**, famously described by pioneering economist **Adam Smith**.

00:38 And what it tells us is that defining value is not as simple as it seems.

00:43 On the game show, you were thinking about each item's **exchange value**, what you could obtain for them at a later time, but in an emergency, like the desert scenario, what matters far more is their **use value**, how helpful they are in your current situation.

00:59 And because we only get to choose one of the options, we also have to consider its **opportunity cost**, or what we lose by giving up the other choice.

00:08 After all, it doesn't matter how much you could get from selling the diamond if you never make it out of the desert.

00:14 Most modern economists deal with the paradox of value by attempting to unify these considerations under the concept of **utility**,

00:22 how well something satisfies a person's wants or needs. **Utility** can apply to anything from the basic need for food to the pleasure of hearing a favorite song,

00:30 and will naturally vary for different people and circumstances.

00:35 A market economy provides us with an easy way to track **utility**.

00:38 Put simply, the **utility** something has to you is reflected by how much you'd be willing to pay for it.

00:44 Now, imagine yourself back in the desert, only this time, you get offered a new diamond or a fresh bottle of water every five minutes.

00:52 If you're like most people, you'll first choose enough water to last the trip, and then as many diamonds as you can carry.

00:58 This is because of something called **marginal utility**,

01:01 and it means that when you choose between diamonds and water, you compare **utility** obtained from every additional bottle of water to every additional diamond.

01:09 And you do this each time an offer is made.

01:12 The first bottle of water is worth more to you than any amount of diamonds, but eventually, you have all the water you need.

01:19 After a while, every additional bottle becomes a burden. That's when you begin to choose diamonds over water.

01:25 And it's not just necessities like water. When it comes to most things, the more of it you acquire, the less useful or enjoyable every additional bit becomes.

01:34 This is the **law of diminishing marginal utility**.

01:37 You might gladly buy two or three helpings of your favorite food, but the fourth would make you nauseated, and the hundredth would spoil before you could even get to it.

01:45 Or you could pay to see the same movie over and over until you got bored of it or spent all of your money. Either way, you'd eventually reach a point where the **marginal utility** for buying another movie ticket became zero.

01:57 **Utility** applies not just to buying things, but to all our decisions.

02:01 And the intuitive way to maximize it and avoid diminishing returns is to vary the way we spend our time and resources.

02:08 After our basic needs are met, we'd theoretically decide to invest in choices only to the point they're useful or enjoyable.

02:15 Of course, how effectively any of us manage to maximize **utility** in real life is another matter.

02:21 But it helps to remember that the ultimate source of value comes from us, the needs we share, the things we enjoy, and the choices we make.