

Keynes's analysis of the stock market and identifying the related policy essay sa...

[Finance](#), [Market](#)



' Keynes's analysis in Chapter 12 of the General Theory of Employment, Interest and Money suggests that capitalism is inherently unstable due to its financial structure'. Discuss outlining Keynes's analysis of the stock market and identifying the related policy conclusions he reaches.

In Chapter 12 of the General Theory of Employment, John Maynard Keynes focused on examining the stock market and how it functions, in the sense of its structure and how it is affected by the behavior of investors because he believed the behavior of the stock market affects the aggregate demand, hence the rest of the economic system. He is most interested in the fluctuations of the rates of investments in the stock market that consequently affect the purchase of physical investment. Keynes believes that these fluctuations in the financial structure render capitalism an unstable system. He examined the determinants of the core fluctuations in the stock market which cause the aggregate demand and the economic situation to waver. Keynes also provided policies that could regulate these variations in the stock market, and hence the capitalist system.

Keynes believed the Stock Market was key to determining the position of the economy. Since aggregate demand determined the position, and the former was most heavily influenced by the changes within the stock market, Keynes deduced that it was the fluctuations in the stock market that caused variations in the economy, destabilizing the capitalist system. Keynes held a macroeconomic view against the conventional view of ' self-righting tendencies' within the society; he believed that the capitalist society can get ' stuck'. To understand the fluctuations of the stock market, Keynes explains

the concept of fundamental uncertainty. Conventional economists, as Keynes believes, 'fit' uncertainty into their theories. He does not see that as appropriate as it is not possible to mathematically calculate uncertainty for certain social aspects. In Keynes, Knowledge and Uncertainty, Lawson states that classical economists disagree with Keynes, since he was unable to provide a quantitative or statistical analysis of the uncertainty that occurs. Lawson however agrees with Keynes as he too believes it is not possible to 'calculate' uncertainty and Keynes has provided powerful theory to explain and support his claims.

Keynes, however, firmly believes that for example, probability distributions on rate of interest cannot be placed for 30 years' time. This occurs because expectations are based on 'existing facts' and 'future events', neither of which can be calculated with full certainty. Hence long-term expectation formation is based on confident decisions as well as the state of confident decisions. Keynes states: "The state of confidence is relevant because it is one of the major factors determining the former [the schedule of marginal efficiency of capital], which is the same thing as the investment-demand schedule" (1936, p149). Rational human beings prefer to make decisions based on correct information. However no such information is available as there is always new information emerging which causes a lack of perfect of information to base expectations on, creating what Keynes terms as fundamental uncertainty. Lawson agrees with the rational expectation hypothesis that Keynes proposes, despite his counter-argument on his statistical evaluation theory.

The Stock Market revalues investments on a daily basis allowing investors to change decisions: When Stock Market prices are high, entrepreneurs invest in their businesses so that it can be sold on the Stock Market for a profit; At low rates, it is more profitable to simply purchase a business that is at a lower price than what it would cost to set up a new one. Keynes describes the result of this as " Investments which are " fixed" for the community are thus made " liquid" for the individual." (1936, p153). These fluctuations in the stock market are due to fundamental uncertainty. Keynes explains that when there is fundamental uncertainty in any aspect, it is rational human nature to fall back on social conventions to help guide decisions. Keynes (1936, p155-56) describes the stock market using an analogy between professional investment and newspaper beauty contest: " Professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole...It is not a case of choosing those which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest.

We have reached the third degree where we devote our intelligence to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth, and higher degrees." The Stock Market decisions work based on conventional values too, where each is not concerned with determining the real stock value, but the market

value the community will place on the stock, before everyone else does. Keynes observes some other features of this situation within the stock market. This type of liquidity not only leads to future fluctuations in physical asset investment, but also creates fluctuations of the daily profit on investments which further influences the market. One of the key themes Keynes observes is that there is plenty of speculative activity in the Stock Market, which is assumed to be an enterprise. However Keynes characterizes the decisions made in an enterprise as those determined by fundamental analysis of underlying aspects, where 'healthy' risk is undertaken while he characterizes speculation as a downright risky process of a sentiment-guessing, which is what actually dominates stock markets.

He carries on claiming that "...it is by no means always the case that speculation predominates over enterprise." (1936, p158) Lawson also agrees that speculators in the market contribute to the instability in the Stock Market but they do not have as great an impact. Despite the fundamental uncertainty that exists, Keynes believes individuals are likely to invest in capital, constructed on whatever expectation they can 'calculate' based on conventional valuation as he believes human nature to be inherently tempted by taking chances. However, with new information emerging on a daily basis, conventional valuations held by people in the market are destabilized. This may lead to eventual breakdown to occur in the stock market, and when that does occur, everyone tries to identify the emotions or environment in the market. They try to realize what the conventional valuation is before everyone else does. This facilitates prices to fall back into

a pattern and re-establish prices within the market. It is due this cycle of uncertainty, speculation and fluctuations that Keynes deems the stock market has inherently unstable.

With such strong view of how influential the stock market and its fluctuations are on the state of the general market and capitalist economy, Keynes devises four key policies to help regulate the stock market. Keynes realizes that the fluctuations of the stock market cannot be eliminated due to its nature so he instead addresses issues to aid in lessening the fluctuations and their impacts on the capitalist economy. The first measure of control Keynes suggests is a policy based on taxation. Keynes reasons it as such: " It is usually agreed that casinos should, in the public interest, be inaccessible and expensive. And perhaps the same is true of Stock Exchanges." Keynes states that speculative activity can be cut down in the stock market if it is more costly. If there is a tax levied on activity within the market, it requires greater commitment and hence reduces the liquidity of the financial markets. This can lead to discouragement of practices of speculative activity since investments will be " permanent and dissoluble, like marriage."

(Keynes 1936, p160)

However, liquidity of the market attracts new investment which will be discouraged by this form of transaction cost and may harm the economy rather than benefit it. The second policy Keynes devises concerns income and investment. This approach requires people to either directly consume their income or directly invest it. " The only cure for the crisis of confidence ... would be to allow the individual no choice between consuming his income

and ordering the production of the specific capital-asset..." (Keynes 1936, p161) With no choice available, there will be none or limited fluctuations, allowing Aggregate Demand to be more stable. However, Keynes is not very comfortable with this policy as it undermines the free choice of people which is against his liberal beliefs, and he also recognizes the various problems that may arise as a lack of choice given to the people. Keynes' third policy related to stabilizing the Stock Market is directed at the firm level. He expresses concern over the speculation that is created due to uncertainty of stability of the firm.

This occurs when there is separation of ownership and controlling parties within a firm. The separation of the two roles can create differences in managerial decisions that can significantly affect the profitability of a firm and hence cause speculation among the investors. This in turn leads to fluctuations in the stock market. However merging the two parties into one would create inefficient decisions as well as lesser investors in the business. Keynes advises the parties should co-exist but with no Agency Problem so as not to create uncertainty in the minds of investors and hence avoid fluctuations. Keynes' last policy is directed towards the socialization of investment. Keynes himself suggested that there should be greater governmental control in stabilizing the Aggregate Demand as it determines the state of the economy. Since Keynes considers the stock market to be the greatest determinant of the Aggregate Demand, he sees it as the government's duty to be involved in assuring a more stabilized economy.

Keynes has analyzed the economy and what he believes to be its biggest influencer in terms of fluctuations, from a viewpoint that traditional economists failed to perceive. Keynes characterizes the stock market to have an inherently unstable structure due to fluctuations, uncertainty and speculation in the market and what he believes is feature of human nature, which in turn makes the capitalists system unstable. “ Even apart from instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than on a mathematical expectation, whether moral or hedonistic or economic.” (Keynes 1936, p161) However, the long-term expectation that people base their decisions on is often stable, or has factors that compensate in overall stability when they can. Keynes produces four different policies to aid producing stability in what he deduces to be an unstable system. Although no policy is without drawbacks and none guarantee a stable capitalist economy, each provides an aspect to control and bring the stock market and in turn the aggregate demand economy towards steadiness.

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