Keynes and Financialization: Beyond *The General Theory*

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Inception

This paper was originally written for Dr. Hugh Grant's class, "Topics in Macroeconomics: The Economics of Keynes," in the Department of Economics at The University of Winnipeg.

Abstract

In this essay, John Maynard Keynes' *General Theory of Employment, Interest, and Money* is used as a starting point for analyzing financialization, a key issue in contemporary economics. The focus is on chapter twelve of this work, since it deconstructs human behaviour and its precarious relationship with financial markets. This essay argues that Keynes' conception of financialization remains highly relevant to understanding the capitalist economy, especially over the last forty years. Hence, the more recent theories of privatized Keynesianism and of the Post-Keynesian school are discussed and compared to The General Theory. This essay concludes that the precocity of our financial system can largely be explained by its speculative nature and its exacerbation of humans' irrational tendencies.

Even apart from the 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 mathematical expectations, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits—a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.

—John Maynard Keynes, *The General Theory of Employment, Interest and Money*

Introduction

The General Theory of Employment, Interest and Money, published in 1936, was John Maynard Keynes' magnum opus and the catalyst for the so-called Keynesian Revolution. This revolution entailed not only a transformation in economic theory, thought, and the prevailing orthodoxy, but had profound policy implications. It provided—and continues to provide—a playbook for policymakers on how a capitalist economy should be managed.

One of the main issues in the different interpretations of Keynes regards his theories' microfoundations.[1] In *The General Theory*, there is no explicit discussion of microfoundations; however, Keynes provides a few critiques of *homo economicus*.[2] Chapter 12, in

[1] Microfoundations are the manner in which individuals and groups are perceived to behave when making economic decisions and the manner in which markets function.

[2] *Homo economicus* is "an idealized human being who acts rationally and with complete knowledge, seeks to maximize personal utility or

particular, is quite a departure from the rest of the work, as Keynes analyzes human behaviour—our animal spirits—and its implications for markets. In fact, he is highly skeptical that the organization of markets around speculation is the socially optimal structure.

One can draw many parallels between Keynes' analysis and financialization. Palley defines financialization as "a process whereby financial markets, financial institutions, and financial elites gain greater influence over economic policy and economic outcomes." (2007) Over the past forty years, since the demise of Keynesianism's dominance in policymaking, the global economy has become increasingly financialized. A significant body of research has emerged dealing with this issue, especially within the Post-Keynesian tradition, a tradition that asserts the continuing relevance of Keynes' writing for the interpretation of the economy today.

To understand financialization from the perspective of Keynes, the obvious starting point is *The General Theory*'s chapter 12. This essay first presents a summary and analysis of this chapter, and then discusses different contemporary theoretical approaches within the context of the policy shifts of the last few decades. In the process, it demonstrates the ongoing importance of his writing to an understanding of today's economy.

The General Theory's Chapter 12

The General Theory was written during the Great Depression. International trade had collapsed, the unemployment rate in most Western countries was reaching as high as 30%, and financial markets—highlighted by the stock market crash in 1929—were in

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satisfaction" and forms an important part of neoclassical economic theory (Efeoğlu and Çalışkan 2019).

disarray. Yet, mainstream economics offered no compelling explanations nor solutions to the economic slump. *The General Theory* offered both.

In chapter 12, entitled "The State of Long-Term Expectation," Keynes deconstructs human behaviour and its relation to markets. It is, perhaps, the section of Keynes's work which provides the greatest insights regarding the issue of financialization. His analysis of financial markets rests upon a lengthy examination of decision-making, expectations, and behaviour.

Decision-Making

Keynes emphasizes that human behaviour as it relates to decision-making and expectations is essential to understanding the functioning of financial markets. At the core of this is an analysis of the expectation of the prospective yield of an asset. This expectation is based on two aspects: existing facts and future events. We can assume that existing facts, such as current consumer demand or amount of capital, are known; however, future events, such as future consumer preferences or wage fluctuations, must be forecast. In other words, we are making a distinction between what we know and what we do not know. Keynes calls the psychological expectations of the future events the state of long-term expectation, the title to chapter 12 (1936).

Keynes notes that "it would be foolish, in forming expectations, to attach great weight to matters which are very uncertain." (1936) As such, we attribute more weight to existing facts rather than predictions about the future when making decisions. Even our predictions are usually projections of the current situation. Therefore, our decisions depend not only on our forecast of future

events, but also on the level of confidence that we place on this forecast.[3]

The Precarious Convention

For Keynes, the prevailing financial decision-making convention seems to be that we assume the “existing state of affairs will continue indefinitely” unless we have a reason to expect otherwise. Though he recognizes its practical utility, he believes that this convention is highly precarious for at least five reasons. First, there has been a gradual increase in the proportion of aggregate investment shares owned by individuals who have little to no knowledge of a given firm’s operations or industry. Second, day-to-day fluctuations in a firm’s profit due to insubstantial reasons (such as seasonal fluctuations of ice sales) have a much larger influence of investment decisions that it should. Third, mass psychology should be accounted for: there may be large opinion changes in the view individuals hold about a given firm or the general economy which are unrelated to prospective yield. These swings, in opinion, may be related to things like politics, specific events, and prejudice (Keynes 1936).

The fourth—and most important—factor deals with the professional investor. Though one might assume that the professional investor would have the expertise to forecast the expected yield of an investment over its lifetime, Keynes believes they are more

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[3] In chapter 11 of The General Theory, Keynes assigns the marginal efficiency of capital an important role in determining investment. It is the expected net rate of return from one additional unit of a capital-asset and is based on the expected yield and the current supply price. Therefore, because the state of confidence about the expected yield influences the marginal efficiency of capital, the latter will also influence investment. Here, however, we are more concerned with directly-related psychological factors.

concerned with “foreseeing changes in the conventional basis of valuation a short time ahead of the general public.” Essentially, investment experts are interested in how an investment will do in shorter-term periods. This means that they do not need to forecast the return of an investment over its lifetime; they only need to forecast how other investors will act in the short term. Of course, he is very critical of this: “The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelop our future. The actual, private object of the most skilled investors today is to beat the gun.” (Keynes 1936)

Keynes writes that for financial markets organized around the desire for liquidity—the ability to readily buy and sell stocks and bonds—this is inevitable. He also notes that, though individual investors are able to take advantage of this liquidity, no such thing exists for communities as a whole. There is an implicit criticism of the financialization of the economy here. Clearly, the value of investment is recognized, however its mechanism—the stock market and investment professionals more concerned with speculating over short-term returns rather than the long-term viability of a particular firm—is criticized by Keynes. As he writes, “investment based on genuine long-term expectation is so difficult today as to be scarcely practicable” and that “there is no clear evidence from experience that the investment policy which is socially advantageous coincides with that which is most profitable.” (Keynes 1936)

Because of human nature and the desire for quick returns, the value of investments on the stock market is distorted, and therefore our original assumption is precarious. The behaviour of investment professionals and the ability to buy or sell shares at any given moment also contributes to this. Those who rationally invest according to long-term yield will have a hard time. As Keynes states, “worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.” (1936)

The final factor which contributes to the precariousness of the original assumption is the confidence of financial institutions to lend money to investors. The other factors focus on decisions that the investor makes but here, Keynes considers the “state of credit” (Keynes 1936). If banks do not have confidence in investors, they will not loan them funds to invest.

Overall, decisions that individuals make are often based on the spontaneity and instincts of human nature rather than on rational calculations. Investment, therefore, depends on both rational decision-making as well as a certain element of risk. Furthermore, the political and social environments have a large impact on how investors, firms, and individuals make decisions. This point is still very relevant today, where governments carefully propose policies which attempt to minimize negative reactions from firms and households. Keynes issues a word of caution, however, noting that not everything depends on irrational psychology. Rather, he is bringing forth considerations that should be noted when analyzing financial expectations: “We are merely reminding ourselves that human decisions affecting the future, whether political or economic, cannot depend on strict mathematical expectation, since the basis for making such calculations does not exist.” (Keynes 1936)

The Evolution of Financial Markets

Prior to the dominance of shareholder capitalism, firms were mainly owned by the entrepreneurs themselves. Therefore, investment depended “on a sufficient supply of individuals of sanguine temperament and constructive impulses” who started businesses for a variety of reasons (not just motivated by profit) (Keynes 1936). The success of these firms would be somewhat random, but also depend on the competence of the entrepreneurs.

Without the element of chance in business, there would be very little investment. Decisions about the future based solely on calculations

would be extremely conservative. In the case of most firms in the past, investment decisions were "irrevocable" (Keynes 1936). Essentially, once an entrepreneur was committed and invested, it was very difficult for them to back out. Therefore, there was no point in revaluating investments. As societies evolved, however, their commercial activity became more and more organized around stock markets, or more financialized. This shareholder system has broad implications for the structure of firms. Unlike in the past, a firm's ownership and management are essentially separate entities. It is this and the development of more sophisticated investment markets that has led to the ability of the investor (the shareholder of a firm) to re-evaluate their investment decision at every given moment. This had obviously had a large impact on decision-making. Entrepreneurs looking to enter a market will not want to create a new firm if the cost is greater than the price at which a similar existing firm could be bought. Furthermore, entrepreneurs may spend more liberally if they believe the stock market might reward them with a profit. Therefore, expectations come from those who trade stocks rather than the entrepreneurs for industries tradeable on the stock market.

As markets become more sophisticated, Keynes predicts that "forecasting the psychology of the market" (which he calls speculation) will come to dominate over actual long-term forecasting of an asset's prospective yield (which he calls enterprise) due to the liquid investment markets. He notes that, in his day, Wall Street had already become much more speculative than the London Stock Exchange due to the fact the Wall Street was more accessible to the average individual (Keynes 1936). Keynes—ever the technocrat—abhors the idea that the fate of the economy depends on the psychological whims of masses of investors and is skeptical of the efficacy of shareholder capitalism.

Writing in the midst of the Great Depression, Keynes' insights into the operation of financial markets have several important

implications for the economy today. Specifically, as financial markets became more sophisticated, it resulted in greater, not less, instability in the economy. This prediction seems to have come to fruition on numerous occasions. In January 2021, the short squeeze or pump and dump of GameStop (and other securities) occurred due to improvements in communications technology (Goldstein 2021). The consequences of this situation show that social media and online forums play an important role in amplifying the irrational tendencies and speculative nature of financial markets.

Greater opportunities for speculation on financial markets increasingly interfere with the investment function—or the manner in which a society puts in place more productive capacity and the direction of economic growth. Present-day research like Simsek (2021) agrees with this this key point from chapter 12, finding that speculation causes financial bubbles. So concerned was Keynes with this trend that he flirted with the idea of removing the investment function from private hands in favour of government control—seeming heresy for a person with such a staunch adherence to liberalism. As will be discussed in the next section, the financialization of markets only really accelerated following the rise and fall of the dominance of Keynesian economic policies.

From Keynesianism to Neoliberalism

Since World War II, there have been two main economic policy programs in Western countries. Keynesianism, the first of these, was dominant until the 1970s during the so-called Golden Age of Capitalism. This can also be described by demand management; governments played an active role in ensuring proper levels of output, much like Keynes envisaged. Though whether this Keynesianism was a true manifestation of Keynes' vision can be disputed, this era was characterized by low unemployment, a strong welfare state, and substantial economic growth. The 1973 oil crisis

and other political and economic factors, however, led to its demise and the emergence of what has been called neoliberalism.

The neoliberal world system is based on economic liberalization, which includes policies such as free trade, deregulation, and fiscal austerity. One of its most interesting features has been its relationship with the financialization of the economy. There have been numerous crises during this period, often originating in the financial sector. It should be noted that in the period from 1945 to 1973, there were no major financial crises in the Western world, a stark contrast to the numerous financial crises of the past forty years.

It is clear the financialization has increased and accelerated under neoliberalism. Philippon shows that the share of the finance and insurance industry in the GDP of the United States has dramatically increased since the 1980s (2011). Furthermore, Palley (2007) found that from 1973 to 2005, financial sector debt as a proportion of total debt grew rapidly from 9.7% to 31.5%. Interestingly, income and wealth inequality have also dramatically risen during this same period (Saez and Zucman 2020). The shift from Keynesianism to neoliberalism and the corresponding financialization of the economy have dramatically altered the global economic structure.

Privatized Keynesianism

Sociologist Colin Crouch has written extensively about neoliberalism. He rejects the idea that Keynesianism was defeated; instead, he proposes that the neoliberal policy regime is actually one of privatized Keynesianism. What distinguishes it from Keynesianism is that “instead of governments taking on debt to stimulate the economy, individuals did so.” (Crouch 2009, 390) Essentially, the debts—of the working and middle classes, and coming mostly from credit cards and housing—are fuelling the economic prosperity of the upper classes.

Recall that Keynes discussed how, as financial markets became more sophisticated, economies became more financialized and increasingly based on investor speculation. Crouch proposes that the global deregulation of financial markets and certain financial innovations have allowed this massive amount of consumer debt to be undertaken due to the "widespread sharing of risk, which made it possible for people to invest in many ventures that would otherwise seem unwise." (2009, 392) This clearly resembles Keynes' critique of irrational investment.

In fact, with regard to the causes of the 2008 global financial crisis, Crouch points to some of the same behavioural issues that Keynes highlighted as being problematic, such as dreadfully wrong expectations and "deficiency of information" (2011). Contrary to the belief of many, the regime of neoliberalism or privatized Keynesianism is not one of perfectly operating free markets; rather, it has been marked by privatization of important social services, increased consumer debt, and the financialization of the economy. Crouch explains that the ramifications of this regime go beyond its economic effects:

> The bases of prosperity shifted from the social democratic formula of working classes supported by government intervention to the neo-liberal conservative one of banks, stock exchanges and financial markets. This fundamental political shift was more profound than anything that could be produced by alternations between nominally social democratic and neo-liberal conservative parties in government as the result of democratic elections. (2009, 392-393)

With the shift from active to laissez-faire governments, the financial markets' worst tendencies have been amplified: they are volatile and subject to the precarious psychological expectations of investors.

Post-Keynesian Models of Financialization

The Post-Keynesian school of economics[4], that takes as its starting point many of Keynes' insights into the nature of human behaviour and the operation of markets, has dealt with the issue of financialization perhaps more than others, even before the 2008 global financial crisis. After 2008, however, there has been an even greater focus on financialization and its link to various capitalist crises.

Eckhard Hein, drawing from the Post-Keynesian (and the related Post-Kaleckian) school, has created a model describing financialization. This model has three main components: pricing and distribution; financing of capital stock and rentiers' income; and saving, investment, and goods market equilibrium. Unlike most other macroeconomic models, the animal spirits (or psychological states) of firm managers are accounted for with the constant α in the following investment function:

$$g = \frac{1}{pK} = \alpha + \beta u + \tau h - \Theta e \gamma = \sigma$$
$$\alpha, \beta, \tau, \Theta \geq 0,$$

where g is the rate of capital accumulation, p is the price, K is the real capital stock, u is the rate of capacity utilisation, h is the profit share β, e is the rentiers' rate of return on equity and bonds, and σ, and β, τ, and Θ are coefficients in the investment function. Hein concludes the following:

> Regarding investment, financialisation has been associated with increasing shareholder power vis-à-vis management

[4] Post-Keynesianism is a heterodox approach to economics, which originates in Keynes' General Theory and draws upon the work of economists such as Joan Robinson, Michał Kalecki, and Nicholas Kaldor.

> and labourers, an increasing rate of return on equity and bonds held by rentiers and decreasing managements' animal spirits with respect to real investment in capital stock, which each have partially negative effects on firms' real investment.[5] (2009)

The model also indicates that financialization leads to "systemic instability." (Hein 2009) What is interesting about Hein's approach is its inclusion of animal spirits. In *The General Theory*, chapter 12 is an interlude to an otherwise technical, mathematical, and relatively straightforward text. Here, however, there is an attempt to integrate Keynes' behavioural critique into a formalized macroeconomic model.

David Zalewski and Charles Whalen also draw from the Post-Keynesian tradition, but take a more institutionalist approach. They show that rising income inequality has accompanied financialization across states. Zalewski and Whalen do, however, disagree with Keynes' belief that the speculative nature of financial markets would increase as they became more sophisticated (2010).

Petra Dünhaupt explains financialization as a combination of the following: "a rise in shareholder value orientation of the firm, redistribution of income and wealth in favor of shareholders and managers at the expense of ordinary works and employees, and more opportunities for debt financed consumption." This is a similar model to Crouch's privatized Keynesianism. Dünhaupt also discusses factors which can destabilize the economy: "an increase in uncertainty, the endogeneity of money and financial fragility, and changes in the distribution of income." (2016) Again, this is an expansion of the ideas Keynes presented in chapter 12. A key

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[5] Hein's model also shows that a higher level of "animal spirits" will lead higher equilibrium levels of the rate of capacity utilisation, rate of profit, and rate of capital accumulation (2009). His paper should be consulted for a full iteration of the model.

distinguishing feature of the Post-Keynesian school from Keynes' work, however, is its emphasis on income distribution. Combining this aspect with financialization, Post-Keynesian economists are among the most important critics of capitalism in its current manifestation.

Conclusion

Financialization remains an important topic in economics. It is intensely intertwined with the global economic system and, therefore, the future of capitalism. Keynes' *General Theory* provides an important foundation for understanding some of the behavioural issues both within financial markets, but also, more broadly, within orthodox economic theory. Regardless of the varying degrees to which the concerns of chapter 12 have been interpreted, it is still of utmost importance to deconstruct the assumptions built into economic models.

Though Keynes provided one of the first important critiques of *homo economicus*, today's behavioural economics is arguably more neoclassical than Keynesian. However, there is an extensive literature within behavioural economics on financial volatility. McDonald seeks to provide a purely behavioural explanation to the 2008 global financial crisis. He notes that "experimental work by behavioural economists has revealed a strong tendency for experimental subjects in laboratory asset-trading games to bid the price of an asset above its fundamental price." (McDonald 2009, 252) This is similar to some of the points raised by Keynes in chapter 12.

It must be pointed out that Keynes was a successful investor, amassing significant wealth for himself and for King's College, Cambridge where he served as bursar. Perhaps his insights into the behaviour of speculators allowed him to win at this game. What is

clear, however, is that he warned us about financialization. We must not let our economic fortunes depend upon our animal spirits.

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