Veblenian stock markets and the efficient markets hypothesis

The efficient markets hypothesis has been described in the literature as the “cornerstone of modern financial theory” (Marsh and Merton, 1986, p. 484), “the centerpiece of neo-classical financial theory” (Andersen, 1983, p. 281), and resting “at the heart of rational expectations macroeconomics” (Ross, 1989, p. 7). But several Post Keynesian critiques of the efficient markets hypothesis have challenged the normative implication that “efficient market prices give the right incentives for the firms’ production and investment decisions and for investors’ portfolio decisions” (Andersen, 1983, p. 281; see also Glickman, 1994). Their findings suggest that the definition of efficiency in the efficient markets hypothesis leads to implications not anticipated by proponents of the hypothesis. Specifically, the phenomena of excessive share price volatility and “rational bubbles” are difficult, if not impossible, to explain satisfactorily within the efficient markets framework.

This paper offers institutionalist support for the Post Keynesian challenges by observing that Veblenian stock markets, heavily influenced by “folk psychology” and subject to episodes of “speculative inflation” that end in financial crises, reinforce the existing critique of the efficient markets hypothesis within the Post Keynesian literature. Ultimately, Veblenian stock markets are shown to be consistent with both Keynes’ “beauty contest” analogy and Davidson’s nonergodic explanation of economic events (1988, pp. 78–79).

In the next section, we explore the conceptual relationship between those implications in terms of informational efficiency and Veblenian stock markets as presented in The Theory of Business Enterprise (Veblen, 1904). In the section following that, we observe another dimension in the relationship between Veblenian stock markets and the modern efficient markets models. The stock market crash of 1987 was

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a particularly troublesome development for efficient markets proponents. Some have attempted to ignore the crash, while others have turned to the abstract models of "rational" bubbles. Finally, we note the interesting and unexpected similarities in one "rational market" explanation of "Black Monday" and Veblen's theory of financial crises.

**Veblen's capital theory and informational efficiency**

The late 1800s and early 1900s constituted the era of great corporate mergers and consolidations put together by J.P. Morgan and other investment bankers. As a critical observer of the changing institutional structure of modern business enterprise system, Veblen was one of the first major economists to analyze the nature and consequences of the modern financial practices, instruments, and markets in an economy dominated by large corporations. Indeed, there is considerable merit in Dirlam's statement: "The distinguishing feature of Veblen's general theory of the economic process is the importance he assigns to the financing of the modern corporation" (Dirlam, 1958, p. 199).

At the heart of Veblen's analysis of the economic process was his theory of business capital. He criticized the neoclassical concept of capital for confusing the older concept of capital as productive goods and the modern business concept of capital as pecuniary assets. As a matter of habit, economists speak of "capital" as a stock of material items required in industrial production—equipment, raw materials, and means of subsistence (1904, pp. 133–134). But the concept of capital went through evolutionary change as the economic system evolved from competitive proprietary business to the modern system dominated by large corporations whose securities are traded in financial markets. The modern concepts of capital as business assets must be understood within the context of the pecuniary logic and institutions of the modern business enterprise system, especially in terms of the role and influence of large corporations.

As a business proposition, "capital" means a fund of money values. . . . This fund of money values (taken as an aggregate) bears a remote and fluctuating relation to the industrial equipment and other items which may (perhaps properly) be included under the old-fashioned concept of industrial capital. [1904, pp. 135–136]

In the evolutionary development of the modern concept of business capital as pecuniary assets, capital was first viewed "as the capitalized
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(aggregated) cost of industrial equipment, etc.—a view which had its significance for economic theory a hundred years ago” (1904, p. 133). But, under the pervasive influence of corporation finance, the basis of capitalization gradually shifted from the cost of material equipment to the earning capacity of the corporation as a going concern (1904, pp. 136–137), with the capitalization proceeding “on the ground afforded by the current rate of interest” (p. 187).

The social implications of the pecuniary concept of business capital are substantial. Since capital means “capitalized putative earning-capacity” expressed in terms of pecuniary (market) value (1904, p. 131), the only requirement is that an asset (whether tangible or intangible) represent a claim to a future stream of income, including anticipated capital gains from price rises (1908, p. 373). The inescapable disconnection between pecuniary values and social welfare is clearly evident. Anything that will yield an income may be capitalized (1908, p. 354). In Veblenian terms, “Disserviceability may be capitalized as readily as serviceability” (1908, p. 354), and any differential advantage that gives rise to income may be capitalized (1908, p. 362). Thus, an income created by using the monopoly powers of large business to retard production can be capitalized, becoming a pecuniary asset (wealth) for its owner, but representing a loss of welfare for society.

Yet another example of the incompatibility between capital as pecuniary assets and social welfare is revealed in Veblen’s argument that the efficiency of the machine process results in lowered costs of production of capital goods. In competitive markets, the lower costs result in increased supplies of outputs, which causes product prices to fall. The decrease in prices reduces earning capacity, which results in lower capitalization (1904, pp. 229–230). Thus, a gain for society at large in the form of decreasing costs of production will be viewed by owners of business capital as imposing a hardship (1904, pp. 230–231).

1 In Veblen’s evolutionary economics, current practices are often not fully recognized in legal rules. Such was the case for corporate capital:

Earning-capacity is practically accepted as the effective basis for capitalization for corporate business concerns, particularly for those whose securities are quoted on the market. It is in the stock market that this effective capitalization takes place. But the law does not recognize such a basis for capitalization; nor are business men generally ready to adopt it in set form, although they constantly have recourse to it, in effect, in operations of investment and of credit extension. [1904, pp. 138–139n]
The role of financial markets

Neoclassical writers of the period in which Veblen wrote *The Theory of Business Enterprise* treated stock exchanges largely as case examples of markets in which equilibrium prices were established under conditions resembling perfect competition (e.g., Marshall, 1907, pp. 326–328). In contrast, Veblen emphasized the role of stock markets in the valuation of corporate capital (as did Keynes later [1936, pp. 150–151]). He explicitly explained that capitalization—the valuation of pecuniary assets—occurs in the financial markets: "All capital put on the market . . . is subjected to an interminable process of valuation and revaluation—i.e., a capitalization and recapitalization—on the basis of its presumptive earning capacity" (1904, p. 154). What today is termed liquidity of investments was recognized by Veblen in his observation that the standardization of corporations’ properties (both tangible and intangible) into “merchantable form” in terms of money and subdivided into numerous “convenient imaginary shares” greatly facilitated the traffic in securities markets (1904, p. 155). Consequently, the capital of corporations (the value of their negotiable securities) fluctuates actively, depending “from hour to hour on the quotations of the stock exchange” (1904, p. 131).

At times, Veblen’s explanation of prices of corporate securities may seem to be an early version of fundamental value theory, which holds that equilibrium prices will be established at levels equal to the discounted value of expected future earnings. If that were so, Veblenian stock markets would have the same relationship to the efficient markets hypothesis as does fundamental value analysis. According to the latter, market prices may temporarily deviate from equilibrium levels (i.e., intrinsic values), creating windows of opportunity for research to identify underpriced or overpriced stocks. The resulting buying or selling activities by informed portfolio managers take prices to equilibrium levels. The efficient markets hypothesis as traditionally formulated is basically an instantaneous adjustment version of fundamental value analysis. Current prices are always equilibrium prices that fully reflect all information. Prices instantly adjust to new equilibrium levels when a change in information disturbs the existing information set.

If read in isolation, Veblen’s repeated statements to the effect that the "value of any given block of capital . . . turns on its earning capacity" (1904, p. 152; see also p. 137) do seem to suggest the fundamental value
theory. Such an interpretation might also seem to be bolstered by a coupling of his explanation of current prices as reflecting the putative or presumptive earnings capacity, which may differ appreciably from the actual earnings capacity (1904, p. 155), with his argument that, after some period of time, prices will be brought in line with the actual earnings capacity. Curiously, such a convergence is indicated in Veblen's discussions of two different situations. First, there was the observation that corporate insiders could profit by knowing that actual earning capacity is different from the expectations of earning capacity by outside investors (see Veblen, 1904, pp. 156–158). For insiders to profit from trading on such knowledge, however, prices must tend toward levels reflecting their actual earning capacities. Second, in the chapter on the modern theory of welfare, Veblen's explanation of financial crises dealt with episodes of "speculative prosperity" during which expected ("putative") earnings capacities rise above actual earning capacity, but ultimately fall to levels reflecting actual earning capacities. (As will be noted in the next section, the convergence of stock prices with actual earning capacity triggered the crisis that ended a period of "speculative prosperity.")

But Veblen's explanation of the process by which stock prices are formed is much more complex than the simple fundamental value theory. In particular, there is a strong psychological factor involved that makes Veblenian stock markets quite similar to Keynes' speculative stock markets. Veblen explained that the frequent fluctuations in stock prices

proceed on variations of confidence on the part of the investors, on current belief as to the probable policy or tactics of the business men in control. on forecasts as to the seasons and the tactics of the guild of politicians, and on the indeterminable, largely instinctive, shifting movements of public sentiment and apprehension. So that under modern conditions the magnitude of the business capital and its mutations from day to day are in great measure a question of folk psychology rather than of material fact. [1904, pp. 148–149, emphasis added]

This passage (as well as others) suggests something different from fundamental value theory. Veblen stated: "The earning-capacity on which the market capitalization runs and about which the traffic in merchantable capital turns is a putative earning-capacity" (1904, p. 155). Clearly, market prices will depend heavily upon the complex psychological factors that determine expectations about earning capacity.
Putative earning-capacity is the outcome of many surmises with respect to prospective earnings and the like; and these surmises will vary from one man to the next, since they proceed on an imperfect, largely conjectural, knowledge of present earning capacity and on the still more imperfectly known future course of the goods market and of corporate policy. [1904, p. 156]

This results in frequent sales of securities as these "surmises" of putative earning capacity change. Those changes, in turn, are largely functions of "folk psychology."

Rather than resembling the fundamental value analysis approach, Veblen's explanation of stock prices suggests the quick responses to changes in information that occur in efficient markets. But if stock prices are heavily influenced by the forces of "folk psychology," rather than by rational decisions based on knowledge of actual earning capacities, how could stock markets be viewed as efficient? An answer is provided by Andersen's observation that, because the assumptions underlying the efficient markets hypothesis information are poorly defined, "any price is an equilibrium price" (Andersen, 1983, p. 283). An important implication noted by Andersen is that the assumptions underlying the efficient markets hypothesis are consistent with Keynesian stock markets, which are influenced more by speculative forces than by the true value of stock, which is based on accurate projections of earnings. To show that a similar implication can be derived for Veblenian stock markets, a brief digression is necessary in the nature of a review of the meaning of efficient prices as clarified by Andersen (1983) and Glickman (1994).

**Informational efficient prices**

If efficient markets mean that financial markets allocate the real capital resources to employments that maximize social welfare, Veblenian stock markets obviously could not be efficient. In fact, such an interpretation seems to be suggested in some of the literature on the efficient markets hypothesis. For example, one could easily infer from the following passage from Fama (1970) that efficient markets are allocatively efficient:

The primary role of the capital market is allocation of ownership of the economy's capital stock. In general terms, the ideal is a market in which prices provide accurate signals for resource allocation: that is, a market in which firms can make production-investment decisions, and investors can choose among the securities that represent ownership of firms'
activities under the assumption that security prices at any time "fully reflect" all available information. A market in which prices always "fully reflect" available information is called "efficient." [p. 383]

Similarly, Ross (1989) argued that, while the relationship between efficient capital markets and Pareto efficiency is "not obvious," it is not unreasonable to think of efficient financial markets as a requirement for a competitive economy to achieve Pareto efficiency.

If the capital market is competitive and efficient then neo-classical reasoning implies that the return that an investor expects to get on an asset will be equal to the opportunity cost of using the funds. [Ross, 1989]

But even those who accept the neoclassical concept of social welfare (which Veblen certainly did not) have had to concede that efficient financial markets are only informationally efficient. And, as both Andersen (1983) and Glickman (1994) have explained, information must be understood within a behavioral context. Information requires only a relevancy for predicting future prices. Prices reflect not only the expectations about the influence of changes in the economic fundamentals on future expected earnings, but also the expectations about how investors will tend to behave in response to perceived changes in expectations. As Andersen (1983) observed, if all investors start to think that all other agents will think that a variable not included in the original information set reveals relevant information, their conjecture becomes validated as each "rationally" acts on basis of that expectation (1983, p. 287). Similarly, Glickman (1994) stated that "a financial event may qualify as information either because it is indicative of underlying real conditions or simply because it is suggestive of possible reactions by market participants" (p. 327).

With information thus defined in behavioral terms, informationally efficient markets become consistent with Keynes' description of financial markets in which investors devote their "intelligences to anticipating what average opinion expect the average opinion to be" (1936, p. 156). Glickman (1994) noted that investors individually actrationally in attempting to "access what fellow investors will think and do in a situation in which what each of them actually think and do depends in turn on his or her assessment of the same question" (p. 336). Thus, informationally efficient markets cannot refute Keynes' statement: "There is no clear evidence from experience that the investment policy which is socially advantageous coincides with that which is most profitable" (1936, p. 157). An additional implication is that rising prices
in a speculative bull market and plummeting prices subsequent to the bursting of a speculative bubble are efficient prices since they both reflect and provide information about investors' expectations about other investors' expectations.

Given the broader definition of information, prices in Veblenian stock markets, which reflect investors' "surmises" about putative earning capacities, are also informationally efficient prices. The putative earning capacity may differ from the actual, but the "folk psychology" results in investors acting on the former until new information about the latter is received. Prices then move quickly to new levels, reflecting the new putative earning capacities. Indeed, Veblen described such price movements in a passage that seems to anticipate in conceptual form the weak-form or random-walk version of the efficient markets hypothesis.

In that weak-form version, prices of stocks cannot be predicted on the basis of historical or current price data. Because information changes on a random basis, stock prices also follow a random pattern. This version of the efficient markets hypothesis is usually traced to the empirical work of the French statistician Bachlier in the early 1900s (see Malkiel, 1989, p. 128). While there is no evidence that Veblen was acquainted with Bachlier's work when he was writing *The Theory of Business Enterprise*, the following passage reveals a conceptual recognition of the random nature of changes in stock prices:

> [T]he earning-capacity which in this way affords ground for the valuation of marketable capital (or for the market capitalization of the securities bought and sold) is not its past or actual earning-capacity, but its presumptive future earning-capacity; so that the fluctuations in the capital market—the varying market capitalization of securities—turn about imagined future events. The forecast in the case may be more or less sagacious, but, however sagacious, *it retains the character of a forecast based on other grounds besides the computation of past results.* [pp. 153–154, emphasis added]

If read in isolation, this passage might perhaps be interpreted as merely stating that stock prices move chaotically, rather than moving to new equilibrium levels as specified in the efficient markets literature. As information about the economic fundamentals changes randomly, price adjustments to new equilibrium levels occur as random movements. Similarly, the tendency of prices in Veblenian markets to adjust to levels representing the capitalized value of the putative earning capacities clearly suggest equilibrium prices. Thus, the price "pulsations" de-
scribed by Veblen (1904, p. 168) in response to changes in investors’ opinions about presumptive earning capacities are clearly random movements in equilibrium prices in response to random changes in “information” about the expected earning capacities.

With the financial markets absorbing huge flotations of securities of corporations that were merged and reorganized during the late 1800s and early 1900s, Veblen argued that common stock represented the valuation of good will (i.e., expected earnings), while bonds represented the collateralized value of tangible capital assets. Veblen’s perspective on the valuation of common stock is particularly relevant to the theme of random movements in stock prices, since a change in presumptive earning capacity falls most immediately on the capitalized value of good will, which “shows the widest freest market fluctuations. The variations in the capitalized value of merchantable good will are relatively wide and unstable, as is shown by the quotations of common stock” (1904, p. 154). Proponents of the efficient markets hypothesis (EMH) who have been frustrated by their inability to identify, even on an ex-post basis, the changes in “information” that would explain why stock prices suddenly and drastically change might take note of the highly intangible nature of the relationship between expectations and the valuation of good will in Veblenian analysis.

While the weak-form version of EMH is clearly evident in Veblen’s analysis of stock markets, he definitely rejected the strong-form version, which asserts that even insider information cannot lead to extraordinary trading profits. Veblen emphasized that stock prices could be manipulated by insiders for their own gain, remarking, “The stock market interest of those men who have the management of industrial corporations is a wide and multifarious one” (1904, p. 160). The putative earning capacity of a given bloc of capital as perceived by outside investors may differ appreciably from the actual earning capacity as known by its managers, and it may readily be to the latter’s interest that such a discrepancy between actual and imputed earning capacity should arise. The managers, armed with inside information, may profit by selling out (or selling short) or by buying (1904, p. 155).

At this juncture, Veblen seemed to stress the ubiquity of stock price manipulation, which would seemingly nullify any possibility of Veblenian stock markets being informationally inefficient. Veblen noted that the personal fortunes being accumulated in the period of great corporate mergers arranged by J.P. Morgan and other large investment bankers came largely in the form of gains from the “traffic in vendible capital” (1904, p. 167).
The aim and substantial significance of the “manipulations” of vendible capital here spoken of is an ever recurring recapitalization of the properties involved, whereby the effective capitalization of the corporations whose securities are the subject of the traffic is increased and decreased from time to time. The fluctuations, or pulsations, of this effective capitalization are shown by the market quotations of the securities. . . . It is out of these variations in capitalization that the gains of the traffic arise, and it is also through the means of these variations of capitalization that the business men engaged in this higher finance are able to control the fortunes of the corporations and to effect their strategic work of coalition and reorganization of business enterprises. Hence this traffic in vendible capital is the pivotal and dominant factor in the modern situation of business and industry. [1904, p. 268]

One point, however, needs to be made with respect to market manipulation and efficient markets. In his attempt to deny that the great bubbles of the past were really episodes of investor irrationality, Garber (1994) argued that investors who purchase stocks based on “the perception of an increased probability of large returns” are acting rationally even if that perception is “triggered . . . by a fraud launched by insiders acting strategically to trick investors” (p. 32). Since Garber used the term “irrational and inefficient pricing and allocational outcomes” (p. 32), rational prices would presumably mean efficient prices. Hence, even the Veblenian markets that were being actively manipulated by insiders would still qualify as efficient markets in the informational sense, as outsider investors were acting “rationally” on the basis of their flawed perceptions of earning capacities.

Rational bubbles, smart crashes, and Veblenian crises

Many observers concluded that the 1987 stock market crash thoroughly invalidated the efficient market hypothesis. Shleifer and Summers (1990), for example, commented that “the stock in the efficient markets hypothesis—at least as it has been traditionally formulated—crashed along with the rest of the market on October 19, 1987” (p. 19, emphasis added). Andersen’s nontraditional formulation of the hypothesis, of course, revealed that the assumptions underlying the hypothesis (with information appropriately defined to include expectations of other investors’ behavior) are consistent with speculative markets. Since such markets inevitably crash, the efficient markets hypothesis is incapable of denying that plummeting prices such as occurred during the October
crashes of 1929 and 1987 are informationally efficient prices, revealing and impounding information about investors’ expectations about other investors’ expectations.

Some efficient markets proponents have attempted to salvage the traditional formulation of the hypothesis by formulating abstract models of “rational bubbles” or “rational frenzies” (see, for example, Romer, 1993, and Bulow and Kemperer, 1994). Such models have been described by Glickman (1994) as exercises in “empty elegance” (p. 339). But one of the less elegant (i.e., less abstract) attempts to explain the 1987 crash in terms of “rational” markets holds particular interest in an examination of Veblenian stock markets. Arbel et al. (1988) claimed that “theories of investor rationality, which have reigned periodically over many years—and also have been vilified and rejected by many scholars over those years—held up reasonably well during the October debacle” (p. 124). Indeed, they asserted:

The tumultuous stock market crash of October 19, 1987 was almost nothing of what so many analysts, investors, and observers believed it was. Instead of a panic, it was the restoration of sobriety and rationality. Instead of destroying confidence, it restored credibility in the market pricing mechanism. ... With sudden swiftness, the crash imposed the rational rules of a remarkable exercise of analytic intelligence. [1988, p. 124]

Arbel et al.’s “smart market crash” argument was based on a rational markets model in which “rational” prices are those consistent with the calculation of the intrinsic values of stocks using Benjamin Graham’s model in a sophisticated process. But the authors conceded that market prices may not always be equal to that intrinsic value, citing Graham’s statement that investors tend to lose a sense of proportion during bull markets, with prices becoming “irrationally” high (1988, pp. 124–125). This, according to Arbel et al., is what occurred in 1987:

To a large extent, financial analysts and their sales representatives, the brokers, created and continuously supported the speculative optimism that preceded the crisis. Evidently carried away by the momentum they had helped to create, they were as surprised by the catastrophe as everyone else. [1988, p. 132]

Nor were insiders able to predict the crash, which was a “macro-generated event” (Arbel et al., 1988, p. 132).

Thus, the market in the months preceding October was overvalued and a “rational” correction was due.
During the early stages of the crash it seems, the market recognized that this "bigger fool" pricing mechanism was about to melt down. Once it was apparent that the bull market was over, investors put an abrupt end to the cycle of irrationality with a correction that was proportional to the degree of overpricing that preceded the crash. [1988. p. 125]

Arbel et al. contended that the crash was actually a rational correction in prices in proportion to the degree of overpricing (1988, p. 125). The market was "smart" by quickly correcting prices rather than allowing the prices to decrease over a longer period of time, which would have been more destabilizing: "By ending the unjustifiably good times, the crash prevented bad times" (1988, p. 124). According to Arbel et al., the Graham valuation model predicted the stock closing prices on Black Monday (1988, p. 133).

To a surprising degree, this interpretation of the events surrounding the 1987 crash paralleled in general form the functioning of the stock market in Veblen's theory of financial instability. In that theory, financial crises abruptly culminate periods of "speculative inflation" that take the form of an inflation in capitalization" (1904, pp. 243–244). Episodes of "speculative prosperity" follow a particular pattern of changes in pecuniary values. A period of "speculative advance" emerges from a period of business prosperity that is initiated by some "traceable favorable disturbance of the course of business" (1904, p. 194). In the typical case, prices begin to rise in one industry or sector of the economy due to increased demand. Under modern conditions, the transmission of the effects of the "favorable disturbance" of business throughout the economy occurs very quickly. In the stock markets, prices of corporate shares rise as expectations of higher earning capacities are quickly capitalized. This is essentially the same explanation for rising stock prices that was given by Arbel et al. for the early stage of the bull market of the 1980s (roughly through 1986).

A more important similarity, however, is in the continued rise in stock prices for some time after the prospects of increased earning capacities have disappeared. The term "speculative prosperity" used by Veblen is significant. He noted that the prosperity is substantially a psychological phenomenon (1904, p. 195), with prices rising throughout the economy because the prosperity becomes "an habitual fact" (1904, p. 194, emphasis added). The business expansion is only partly a response to actual increases in demand. To a larger degree, it is in response to "a lively anticipation of advanced demand" that "pushes up prices in
remoter lines of industry" (1904, p. 195). That anticipation proves largely false as a combination of rising costs and weakening demand eliminates opportunities for higher earning capacities. The false prosperity may continue for a time, however, because the psychological effects of prosperity produce a "habit of buoyancy, or speculative recklessness, which grows up in any business community under such circumstances" (1904, p. 196). Such a development corresponds to the period of "irrational" rises in stock prices noted by Arbel et al. in the months preceding the 1987 crash.

The main thrust of the Arbel et al. thesis was that the stock markets would ultimately recognize that prices were "irrationally" high and quickly bring those prices down to levels commensurate with their fundamental values. Similarly, the period of "buoyancy, or speculative recklessness" comes to an end as Veblenian stock markets perceive that share prices are out of line with actual earning capacities. The "current quotations" or "apprehended future quotations" of securities on the stock markets will quickly be adjusted to reflect the new perception of the actual earning capacities (1904, pp. 192–193).

Veblen did not speak explicitly about a stock market crash in his analysis of the crisis that ends the period of speculative inflation, but a drastic drop in stock prices is definitely implied in his discussion of the mass liquidation that "brings on an abrupt readjustment in the crises which follows inflation" (1904, p. 244). While the liquidation of business assets frequently started with the failure of some banking house, usually one whose funds have been "tied up" in "unwise" loans to industrial enterprises (p. 205), falling stock prices provided the information that triggered a calling of loans. Some creditors apprehended "that the property represented by the collateral is overcapitalized, as tested by current quotations, or by the apprehended future quotations, of the securities in question" (1904, p. 192, emphasis added). Thus:

[T]he immediate occasion for such a crisis ... is that there arises a practical discrepancy between the earlier effective capitalization on which the collateral has been accepted by the creditors, and the subsequent effective capitalization of the same collateral shown by the quotations and sales of the securities on the market. [1904, p. 193, emphasis added]

The absence of any real attention to the role of business debt by Arbel et al. has no significant bearing on the degree to which their explanation of the 1987 crash is similar to the behavior of stock markets in Veblen's
theory of financial instability. Veblen did, of course, emphasize the role of credit expansion in his theory of business capital, and the speculative advance in stock prices is encouraged as business capital is expanded to a maximum by firms using the increased capital values (higher market prices of shares) as collateral for additional debt. But he explicitly noted that “it can be shown on similar lines that a period of prosperity will bring on a like discrepancy between putative and actual earning-capacity, and therefore between putative and eventual capitalization of collateral, even independently of the expansion effected by loan credit” (1904, p. 194, emphasis in original). The addition of credit/debt simply magnifies the speculative advances and the subsequent crises.

Indeed, there is a hint of that phenomenon in Arbel et al.’s observation that shares of firms undergoing corporate restructuring—involving in merger and acquisitions or leveraged buyouts—fueled the stock market in the months before the 1987 crash and suffered the largest price decreases during the crash (Arbel et al., 1988, pp. 125–126). Since those corporate restructuring activities involved massive increases in debt, the price movements in the stock market followed the pattern described by Veblen.

Concluding statement

Veblen’s views of pecuniary valuation in financial markets empower the Post Keynesian critique of “efficient markets”; stock price expectations are formed by Veblen’s player after interpreting information about capital’s expected future earnings (Keynes’ “enterprise”) as well as considering the shifting movements of public sentiment (Keynes’ “speculation”). The behavioral context of information in Veblen’s folk psychology theory of stock price expectations is consistent with Keynes’ “beauty contest” analogy. Each is a theory of rational deviation from intrinsic value theory since the emphasis is on the reactions of the general market participants, and underlying economic conditions are secondary.

Further, the Post Keynesian analyses that have challenged the normative appeal of the efficient markets hypothesis are enhanced by the notion that Veblenian stock markets qualify as informationally efficient. In fact, the efficiency of Veblenian stock markets may actually do more to discredit the significance of stock markets being “efficient” than Andersen’s revelation that Keynesian speculative stock markets are consistent with the assumptions underlying the efficient markets hypothesis. Even more so than Keynesian stock markets, Veblenian stock
markets fail to allocate real capital to employments that maximize social welfare. Thus, the “efficiency” of those markets renders the concept of efficient stock markets virtually meaningless.

REFERENCES


