The Hidden Purposes of High Finance

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No one questions the usefulness of "low" finance: the ability to use checks, banknotes, and credit cards rather than having to cart around chests of silver, scales, and reagents to assay purity, and needing armed guards to protect the silver – and more guards to watch the first set of guards – has obvious efficiencies. So does the ability of households to borrow and lend in order not to be forced to match income and expenditure every day, week, month, or year.

But what use is "high" finance?

Economists' conventional description depicts high finance as providing us with three types of utility. First, it allows for many savers to pool their wealth to finance large enterprises that can achieve the efficiencies of scale possible from capital-intensive modern industry.

Second, high finance provides an arena to curb the worst abuses by managers of large corporations. Shareholder democracy simply does not work, but managers' fear that if the stock price drops too low they will be out on their ears provides a useful restraint.

Finally, high finance allows for portfolio diversification, so that individual investors can seek high expected returns without being forced to assume large, idiosyncratic risks of bankruptcy and poverty.

But these are the benefits of high finance as they apply to the ideal world of economists – that is, a world of rational utilitarian actors who are skilled calculators of expected utility under uncertainty, who are masters of dynamic programming, and who breathe stochastic calculus in their daily life. We do not live in such a world.

Economists have spent their lives attempting to evolve theories that would account for how salient features of reality might emerge if we did live in their ideal world, but since we don't, their theoretical enterprise is of doubtful utility. It is like describing how one could bake a delicious wedding cake using only honey, bicarbonate of soda, and raw eggplant.

If we take the world as it really is, we quickly see that high finance performs two further tasks that advance our collective economic welfare. It induces us to save, accumulate, and invest by promising us safe and liquid investments even in extraordinary times. It also induces us to save and invest as a prerequisite to indulging our love of gambling, and as a byproduct of it.

It is a fact that we are much happier saving and accumulating, and that we are much more likely to do so when we think that the resources we have saved and accumulated are at hand. It is also true that when we invest our wealth – in Pfizer's intellectual property, factories in Shenzhen, worldwide distribution networks, or shopping malls in Atlanta – it is not, in fact, at hand. Our invested wealth can only be made to appear liquid to any one of us, and only if there is no general shift in our collective desire for liquidity.

And it is also a fact that we are happier saving and accumulating if we receive positive and negative feedback on our decisions on a time scale that allows us to believe that we can do better next time by altering our strategy – hence marketwatch.com and CNN/Money.

Of course investors who believe that their wealth is securely liquid, and that they are adding value for themselves by buying and selling are suffering from a delusion. Our financial wealth is not liquid in an emergency. And when we buy and sell, we are enriching not ourselves, but the specialists and market makers.

But we benefit from these delusions. Psychologically, we are naturally impatient, so it is good for us to believe that our wealth is safe and secure, and that we can add to it through skillful acts of investment, because that delusion makes us behave less impatiently. And, collectively, that delusion boosts our savings, and thus our capital stock, which on turn boosts all of our wages and salaries as well.

Seventy-three years ago, John Maynard Keynes thought about the reform and regulation of financial markets from the perspective of the first three purposes and found himself "moved toward... mak[ing] the purchase of an investment permanent and indissoluble, like marriage..." But he immediately drew back: the fact "that each individual investor flatters himself that his commitment is 'liquid' (though this cannot be true for all investors collectively) calms his nerves and makes him much more willing to run a risk..."

Moreover, for Keynes, "[t]he game of professional investment is intolerably boring and over-exacting to anyone who is entirely exempt from the gambling instinct; whilst he who has it must pay to this propensity the appropriate toll..."

It is for these reasons that we have seemed frozen for the past generation or two whenever we have contemplated reforming our system of financial regulation. And it is why, even in the face of a severe financial crisis, we remain frozen today.

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