

Beauty Contest Metaphor. *International Encyclopedia of the Social Sciences*. Ed. William A. Darity, Jr. Vol. 1. 2<sup>nd</sup> ed. Detroit: Macmillan Reference USA, 2008. p269-270.

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## Beauty Contest Metaphor

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John Maynard Keynes, in his famous chapter 12 of the *General Theory of Employment, Interest, and Money* (1936), wrote of the ways in which “enterprise” (the attentive study of fundamentals) would become less important to the workings of the stock market, and of the ways that “speculation” (predicting the psychology of the crowd under conditions of radical uncertainty) would increasingly determine market outcomes. In doing so, he likened speculation to a beauty contest run by a newspaper, where the winner is not the candidate that is the most beautiful (by some set standard), but the candidate that most people think is the most beautiful. If one wants to win, therefore, one does not choose the candidate one actually thinks is the most beautiful, but the candidate one thinks most other people will think is the most beautiful.

But there is a problem. As soon as one thinks this way, one imagines others may be thinking this way as well. One must then choose not the candidate one thinks most people think is the most beautiful, but the candidate one thinks most people think most people think is most beautiful. But as soon as one thinks this way, one again imagines others will think this way as well, and so on and so forth. This phenomenon, when agents consider not only their own forecasts but the forecasts of others and their forecasts of others, has been referred to as higher-order beliefs (Monnin 2004) or endogenous uncertainty (Kurz 1974).

It is easy to see how this approach can be used as a metaphor for the stock market. A trader is not interested, strictly speaking, in the “fundamentals” of a company, such as market outlook and technological capabilities, because if no one else buys that stock it really doesn't matter. Its price will not rise. On the other hand, even if the fundamentals of a company do not look promising, if others believe that it is a good buy, for whatever reason, they will buy the stock and its price will rise. The lesson is not to buy the stock of a company one thinks is the best by some particular standard, but to buy the stock of a company one thinks others think is the best. But this soon leads to the same conundrum as occurs in the beauty contest, with the investor perpetually trying to stay one step ahead of everyone else. Keynes wrote that on a normal day this could expand to up to “four or five” iterations. In other words, a trader will be trying to anticipate what stocks on average “people think that people think that people think that people think” are the best. At this point, values are completely separated from underlying fundamentals, and some of the best minds are engaged not in productive enterprise but guessing at mass psychology, subject to waves of optimism and pessimism, sometimes in response to phenomena difficult to get a handle on, or even to seemingly irrelevant factors. It has been shown, both theoretically and empirically, that such markets are highly volatile (see Monnin 2004).

**SEE ALSO** *Casino Capitalism ; Economic Psychology ; Economics, Keynesian ; Financial Instability Hypothesis ;*  
Page 270 *Financial Markets ; Keynes, John Maynard ; Speculation ; Stock Exchanges ; Stocks*

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**Source Citation:** "Beauty Contest Metaphor." International Encyclopedia of the Social Sciences. Ed. William A. Darity, Jr.. Vol. 1. 2<sup>nd</sup> ed. Detroit: Macmillan Reference USA, 2008. 269-270. Gale Virtual Reference Library. Gale. Public Trial Site. 9 Jan. 2008 <[http://go.galegroup.com/ps/start.do?p=GVRL&u=pub\\_gvrl](http://go.galegroup.com/ps/start.do?p=GVRL&u=pub_gvrl)>.

**Gale Document Number:** GALE|CX3045300171