

OPINION ARTICLE

## Downturn eroded the credibility of financial markets



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This article was published in *Business Daily*, January 13th 2009.

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The financial crisis, credit crunch, and ensuing economic downturn have severely damaged the credibility of financial markets, institutions, and traders.

More and more people are claiming that markets are characterised by irrationality, bubbles, fads, and frenzies, and that economic actors are driven by behavioural biases.

George Soros's recent book on the credit crisis is a good example of this line of thinking. He even suggests that established financial theory is obsolete.

His view, in essence, means that the current financial crisis is the final proof that markets do not process information efficiently. If this is true, we are closer to John Maynard Keynes's view of the market as a casino than to Friedrich von Hayek's view of it as a marvelous mechanism for processing dispersed information.

For example, the recent spike in oil prices would have been driven by an irrational frenzy in futures markets. Market operators would have miscalculated systematically, been overconfident about their information, and overreacted to news.

The problems we see in the financial markets have very much to do with lack of good information, misaligned incentives, and, in fact, rational responses to the environment. When information is scarce and unevenly distributed, prices may well depart from the reality of fundamentals.

We see this when new technologies arrive on the scene. The Internet bubble is the most recent example, but a similar phenomenon occurred with the construction of railways more than a century ago.

It can be argued that the sophisticated loan packages created by banks in recent years are, likewise, a new and unknown product, so information and experience to aid pricing has been scarce and dispersed.

In such circumstances, prices may well move far from the fundamentals as assessed by a hypothetical collective wisdom that would pool all information in the market. Trading on the momentum of price movements may then become a rational activity that becomes self-fulfilling, as investors decide to "ride the bubble" while it lasts.

The bubble is inflated further by the asymmetry between those who bet that prices will rise and buy, and those who forecast a fall, but stay out because to sell short is too costly.

This means that important and relatively persistent departures of prices from fundamental values are possible, and even likely, when information is dispersed – but that a correction to align them with reality will always follow. Eventually, stock prices do reflect the fundamentals of the economy. This explains why the market can look like Keynes's casino in the short term and like Hayek's marvel in the long term.