

OPINION ARTICLE

Fads, Frenzies, and Finance



Xavier Vives, Academic Director SP-SP Public-Private Sector Research, IESE Business School and Professor of Economics and Financial Management

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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 characterized by irrationality, bubbles, fads, and frenzies, and that economic actors are driven by behavioral 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 He even suggests that established financial theory is obsolete.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. I believe, however, that there is another explanation for these phenomena, which is based on rational calculation and information processing by institutions and traders.

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.

So how does this explain the overexposure of many institutions to sub-prime mortgage risk and the collapse of the interbank market? Were banks that chose to securitize sub-prime loans instead of keeping them on their balance sheets behaving irrationally? Again, informational asymmetries and misaligned incentives are at the heart of what happened.

Keeping those loans on the books would have meant that a bank would have had to incur a large capital adequacy provision and monitor the loans' performance, at a cost to itself. Securitization avoided such costs and placed the new product advantageously – with the complicity of rating agencies, which stood to profit from investors' inexperience and lack of information. Executives collected generous bonuses, and equity holders were protected by limited liability.

A probable cause of the collapse of the interbank market is precisely informational failure. This is a well-known phenomenon; indeed the study of the market for automotive "lemons" won George Akerlof the Nobel Prize. Banks still don't trust each other, since each wonders how many skeletons the other has in its closet. There is no irrationality here.

The debate over the irrationality of financial markets is no mere academic argument. If we believe that economic actors are irrational, then we will enact paternalistic policies aimed at controlling behavior or bailing out failed agents and institutions, which could be self-defeating and even dangerous. This may include restrictions on investments by institutions and individuals and intrusive regulation that limits, or dictates, their conduct in the market.

The calls to curb speculation in derivatives markets or short sales have this flavor. If, on the other hand, we believe that economic actors will respond rationally to incentives and information, then we can usefully reform regulatory frameworks with well-targeted measures, including restrictions on off-balance sheet vehicles, tougher disclosure requirements, and controls on rating agencies' conflicts of interests.