Market Efficiency, Behavioral Finance, and Bubbles and Crises   TW

An efficient financial market is forward looking and responds only to news. It doesn't have internal dynamics like momentum

Since all publically available information is already incorporated into the price it is extremely hard to beat the market return except by taking on more risk.

However, contrary to what was often believed this type of efficiency doesn't guarantee that the market always sets equilibrium prices.

The neuro and behavioral finance approaches argues that there are sometimes limits to arbitrage (stabilizing speculation) that allow imperfect market behavior to affect prices.

Such behavior can also affect international (and domestic) capital flows and lead to over expansions of credit and subsequent crises.

Financial market imperfections can occur through rational behavior motivated by perverse incentives generated by such factors as moral hazard, principal-agent problems, and inefficient compensation schemes, and due to limited information, high uncertainty, and the adoption of defective mental models or theories to analyze complex situations

Behavioral and neuro economics and finance adds that while evolution has led to our brains being well adapted to deal with many issues complex financial issues are not one of these.
We have difficulties analyzing low probability events,
see patterns in random numbers, and
often suffer from such traits as hubris, over optimism, myopia, confirmation bias, and the "this time its different" syndrome.

Such factors can lead to bubbles and crashes in capital flows, credit expansion, and asset prices.

Because of its special nature competition isn't always sufficient to provide safe outcomes in the financial sector. Thus there is a strong case for prudential regulation and supervision, but these have often worked quite poorly.