

The Global Financial Crisis and the Efficient Market Hypothesis: What Have We Learned?

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Abstract

The sharp economic downturn and turmoil in the financial markets, commonly referred to as the “global financial crisis,” has spawned an impressive outpouring of blame. The efficient market hypothesis (EMH)—the idea that competitive financial markets exploit all available information when setting security prices—has been singled out for particular attention. Like all successful theories, the EMH has major limitations, even as it continues to provide the foundation for not only past accomplishment, but future advances in the field of finance.

Despite the theory's undoubted limitations, the claim that it is responsible for the current worldwide crisis seems wildly exaggerated. This essay shows the misreading of the theory and logical inconsistencies involved in popular arguments that EMH played a significant role in (1) the formation of the real estate and stock market bubbles, (2) investment practitioners' miscalculation of risks, and (3) the failure of regulators to recognize the bubbles and avert the crisis. At the same time, the author argues that the collapse of Lehman Brothers and other large financial institutions, far from resulting from excessive faith in efficient markets, reflects a failure to heed the lessons of efficient markets. In the author's words, “To me, Lehman's demise conclusively demonstrates that, in a competitive capital market, if you take massive risky positions financed with extraordinary leverage, you are bound to lose big one day—no matter how large and venerable you are.”

Finally, behavioral finance, widely considered as challenging and even supplanting efficient markets theory, is viewed in this article as complementing if not reinforcing efficient markets theory. As the author says, “it takes a theory to beat a theory.” Behavioralism, for all its important contributions to finance literature, is described as not a theory but rather “a collection of ideas and results”—one that depends for its existence on the theory of efficient markets.

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