When The Market Cannot Do it All! Informational Efficiency & Information Dispersion

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Abstract

Apparently contradictory evidence has accumulated regarding the extent to which financial markets are informationally efficient. Shedding new light on this old debate, we show that differences in the distribution of private information may explain why informational efficiency can vary greatly across markets. Our findings are unequivocal: markets are informationally efficient when private information is concentrated in the hands of a few whereas they are not when private information is dispersed across traders. A dynamic Bayesian learning model helps to illustrate why inferring others' private information from prices takes more time when information is more dispersed.