‘The Crisis and Beyond’ is an open ended topic; with time there are new developments, new facts come to light, new analyses and opinions are published. Under this heading I want to comment from time to time on some of these.

In a video interview on bigthink, Nobel Laureate Robert Engle came out in defense of short selling. Here is the complete passage:

**Question:** What is short selling, and should it be allowed?

**Robert Engle:** Well if you’ve got information about a company, or you believe that a company is undervalued, you can go out and buy their stock and you can make some profit on it. And if a lot of people feel like this company is undervalued and go out and buy the stock, the stock price will go up reflecting the higher value of this company. You might have information because you trade with them or because you’ve done some research on them.

On the other hand, if you have information that a company is not as good as its stock market valuation, you don’t have a way to sell that stock unless you already own it. And so that information doesn’t get incorporated in the company’s stock price as fast if you don’t allow short selling. And so allowing short selling is allowing people to sell – instead of having to buy the stock and then sell it, which doesn’t do much; allow them to sell it, and then buy it. In which case they can express that information and the idea is that you would get more accurate valuation of companies by letting people express both their positive information and their negative information through either long or short selling.

URL: [http://bigthink.com/ideas/21579](http://bigthink.com/ideas/21579)

Engle’s argument would be quite reasonable if financial markets actually behaved in the manner assumed by the Efficient Market Hypothesis (EMH) as Professor Engle evidently believes. The EMH implicitly assumes that: 1. all ‘information’ is genuine, reflecting aspects of a relevant reality; 2. all agents act rationally on the available information; and 3. assets are rationally priced given available information. Scholars working in behavioral finance have questioned all of these assumptions. (See for example the article by Tuckett in this Special Issue.) The financial crisis has further eroded belief in the validity of the EMH.

In the present context it suffices to point out that a large and increasing share of trading in financial markets, particularly computerized trading, is simply based on trend following. The individual speculator believes that he can spot both the beginning and the end of a trend ahead of other speculators and thus profit at their expense. While this may be true of a few, it is in the aggregate evidently a delusion! As more and more speculators jump onto a trend, they strengthen it without supplying any genuine information about the situation of the company in whose stock they are trading.

When short selling is used to drive down the value of a stock or of a currency, other investors may mistakenly believe that the declining price reflects genuine problems at the underlying firm or country. In the extreme, the firm may be driven into bankruptcy, a country into default.
Early in February 2010, the managers of some of the biggest hedge funds gathered in New York to plan a concerted short selling attack on the Euro. Earlier, some of the same hedge funds had bet heavily against the already declining stock of Lehman Brothers, accelerating the decline that ultimately led to the collapse of the firm.

These and other episodes involving credit default swaps are described in a February 26, 2010 article in the Wall Street Journal. URL: http://online.wsj.com/article/NA_WSJ_PUB:SB10001424052748703795004575087741848074392.html.

I maintain my position that short selling (especially on the ‘down tick’) and naked credit default swaps should be outlawed.