Failure of Stock Prices to Discipline Managers in a Rational Expectations Economy

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In this paper we show that even a strongly efficient stock market is, by itself, insufficient to discipline managers who may hold incorrect beliefs about investors' behavior and their decision rules. Instead of disciplining the managers, the stock market may generate prices that reinforce these incorrect beliefs. When this happens, the disciplining of managers must be accomplished through other mechanisms, such as through markets for managerial labor, mergers and takeovers, the financial press, and education. These alternative mechanisms may produce slower disciplinary reactions than the stock market.