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Why do people violate no-trade theorems? A diagnostic test *

Evidence from both the lab and field suggests that people frequently trade on the basis of private information in violation of no-trade theorems. Why? We report an experiment designed to distinguish between three prominent explanations: cursedness, relative overconfidence and signal attachment (i.e., overweighting of one's own signal).

Our experimental design takes a diagnostic approach, stripping these potential explanations away one-by-one over a series of treatments. In some of our treatments the accuracy of each subject's private signal depends on the subject's skill, generating scope for relative overconfidence. In further treatments we eliminate relative overconfidence as a source for trade by instead implementing signals with an exogenous common accuracy. Likewise, in some of our treatments, subjects must extract information from their counterparts' trading strategies, generating scope for cursed beliefs, while in others we ease this possibility by making signals public information. The public information treatment also allows us to evaluate whether subjects react asymmetrically to their own signal and the signal of their counterpart.

Treatment level analysis suggests behavior is consistent with cursedness, relative overconfidence and signal attachment. These forces operate independently of subject confusion and noise. We use our treatment design and elicited beliefs to identify the parameters of a structural model, which allows us to quantify the effect of each channel and their interactions. Structural estimates imply that cursedness plays a major role: it has the largest effect on motivating trade, and it also amplifies the effect of relative overconfidence.

* (joint with Ryan Oprea)