INCENTIVES FOR INFORMATION PRODUCTION IN MARKETS WHERE PRICES AFFECT REAL INVESTMENT

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Abstract
We analyze information production incentives for traders in financial markets, when firms condition investment decisions on information revealed through stock prices. We show that traders' private value of information about a firm's investment project increases with the ex ante likelihood the project will be undertaken. This generates an informational amplification effect of shocks to firm value. Information production by traders may exhibit strategic complementarities for projects that would not be undertaken in the absence of positive news from the stock market. A small decline in fundamentals can lead to a market breakdown where information production ceases, and investment and firm value collapse. Our theory sheds light on how productivity shocks are amplified over the business cycle. (JEL: G14, G31, E32)

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