Macroeconomics of Financial Markets

ECON 712, Session 1 - Fall 2013

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Week 4 - Bubbles
Beauty Contests

"Professional investment may be likened to those newspaper competitions in which the competitors have to pick out six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view”

J.M. Keynes (1936)
Introduction

- Why a rational representative investor model of asset prices does not generate bubbles?
- **Martingale property**: LIE (Law of iterated expectations).
Introduction

- Why a rational representative investor model of asset prices does not generate bubbles?

- **Martingale property**: LIE (Law of iterated expectations).

- This is not the case with heterogeneity, since in general, average expectations fail to satisfy LIE.

- When private information is heterogeneous, agents rely excessively in public signals. Hence
  - Mean price path deviates from consensus liquidation values
  - Prices exhibit inertia.
Fail of LIE with heterogeneous information

- LIE with private information

\[ E_{it} (E_{i,t+1}(\theta)) = E_{it} (\theta) \]

- LIE with public information

\[ E^*_t (E^*_{t+1}(\theta)) = E^*_t (\theta) \]

- LIE fails taking averages with asymmetric information

\[ \bar{E}_t (\bar{E}_{t+1}(\theta)) \neq \bar{E}_t (\theta) \]
Basics

- Information at all dates:
  - $\theta \sim \mathcal{N}(y, \frac{1}{\alpha})$
  - Signals: $x_i = \theta + \epsilon_i$, where $\epsilon_i \sim \mathcal{N}(0, \frac{1}{\beta})$

- Average expectation of average expectations.

$$\overline{E}_{t}^{T-t}(\theta) \equiv \overline{E}_{t} \left( \overline{E}_{t+1} \left( \ldots \overline{E}_{T-1}(\theta) \right) \right) = \left( 1 - \left( \frac{\beta}{\alpha + \beta} \right)^{T-t} \right) y + \left( \frac{\beta}{\alpha + \beta} \right)^{T-t} \theta$$

- See that

$$\overline{E}_{t}^{T-t}(\theta) \neq \overline{E}_{t}(\theta) = \left( 1 - \left( \frac{\beta}{\alpha + \beta} \right) \right) y + \left( \frac{\beta}{\alpha + \beta} \right) \theta$$
No learning through prices

If

\[ q_t = \bar{E}_t(p_{t+1}) \]

then

\[ q_t = \left(1 - \left(\frac{\beta}{\alpha + \beta}\right)^{T-t}\right) y + \left(\frac{\beta}{\alpha + \beta}\right)^{T-t} \theta \]

How to obtain the equation for \( q_t \)?

How to deal with learning from past prices?
Model

- Single risky asset, liquidated at $T + 1$ but traded from 1 to $T$.
- Liquidation value $\theta$ is determined before date 1. $\theta \sim \mathcal{N}(y, \frac{1}{\alpha})$
- Overlapping generation of no wealth constrained traders, each living for two periods and consuming in the second period. $u(c) = -e^{-\frac{c}{\tau}}$
- Information set: $\{y, p_1, p_2, .., p_t, x_{it}\}$ where $x_{it} = \theta + \epsilon_{it}$ and $\epsilon_{it} \sim \mathcal{N}(0, \frac{1}{\beta})$
- Each period exogenous net supply of assets $s_t \sim \mathcal{N}(0, \frac{1}{\gamma})$
Path of fundamental value

When each new trader is born, they do not know the true value of \( C_1 \). However, for a trader \( i \) born at date \( t \), there are two sources of information. First, the full history of past and current prices are available, including the ex ante mean \( y \) of \( C_1 \). Second, this trader observes the realization of a private signal \( x_i = C_1 + v_i \).
Private Information

where it is a normally distributed noiseterm with mean 0 and variance \( \frac{1}{\sigma^2} \). We assume that the noise terms \( f_{it} \) are i.i.d. across individuals \( i \) and across time \( t \). There is no other source of information for the trader. In particular, the private signals of the previous generation of traders are not observable. Hence, the information set of trader \( i \) at date \( t \) is \( y, p_1, p_2, \frac{1}{\sigma^2}, p_t, x_{it} \) where \( p_t \) is the price of the asset at date \( t \) (Figure 2). As a convention, we take \( p_{T+1} = \frac{1}{\sigma^2} \). All traders have the exponential utility function \( u(c) = \frac{1}{\alpha} e^{-\frac{c}{\alpha}} \) defined on consumption \( c \) when they are old. The parameter \( \frac{1}{\alpha} \) is the reciprocal of the absolute risk aversion, and we shall refer to it as the traders’ risk tolerance. Finally, in each trading period, we assume that there is an exogenous noisy net supply of the asset, \( s_t \), distributed normally with mean 0 and precision \( \frac{1}{\sigma^3} \). The supply noise is independent over time, and independent of the fundamentals and the noise in traders’ information. The modeling device of noisy supply is commonly adopted in rational expectations models so as to prevent the price from being a fully revealing signal of the fundamentals. Noisy supply is sometimes justified as the result of noise traders or in terms of the subjective uncertainty facing traders on the “free float” of the asset that is genuinely available for sale [see Easley and O’Hara (2001), footnote 9, page 52].

One potentially unsatisfactory feature of our setup is the feature that random net supplies are independent draws over time. When there are overlapping generations of traders, such an assumption is
Price at date $T$

- Trader $i$’s demand at date $T$
  
  $$D_{iT} = \frac{\tau}{V_{iT}(\theta)} (E_{iT}(\theta) - p_T)$$

- Market clearing is given by
  
  $$D_T = \frac{\tau}{V_T(\theta)} (\bar{E}_T(\theta) - p_T) = s_T$$

- Then, the price at date $T$ is
  
  $$p_T = \bar{E}_T(\theta) - \frac{V_T(\theta)}{\tau} s_T$$
Price at date $t$

- The asset price at date $T-1$ is
  \[
  p_{T-1} = \bar{E}_{T-1}(p_T) - \frac{V_{T-1}(p_T)}{\tau} s_{T-1} = \bar{E}_{T-1} \bar{E}_T(\theta) - \frac{V_{T-1}(p_T)}{\tau} s_{T-1}
  \]

- The asset price at a general date $t$ is
  \[
  p_t = \underbrace{\bar{E}_t \bar{E}_{t+1} \ldots \bar{E}_T(\theta)}_{q_t = \bar{E}_t^{T-t}(\theta)} - \frac{V_t(p_{t+1})}{\tau} s_t
  \]
Main results

We will answer these questions by means of three propositions. Figure 3 illustrates our results. The line labelled as $p_t$ is the mean of the price path with respect to the noisy realizations of supply. The line labelled as $E_t(\theta)$ is the mean path of the average expectation of $y$ with respect to the noisy realizations of supply. The mean price path deviates systematically from the mean path of average expectations, and the price path lies further away from the true value than the average expectations. So, prices not only fail to reflect the consensus on true fundamental value, but are further away from the true value. Also, the initial adjustment in price at date 1 is too sluggish, failing to reflect the true extent of the shift in fundamentals from $y$ to $\theta$. Thereafter, the price does adjust, but slowly. It only catches up with the average expectations of fundamentals at the last trading date.

The line labelled by $q_t$ is the path followed by the naive iterated expectation given by Equation (3) in Section 1 that ignores the information given by prices. The mean path for price lies between this path and the mean path for average expectations. One of our results below identifies a limiting case for when the mean price path coincides with the naive iterated expectations path.

In what follows, we denote by $E_s(\theta)$ the expectation with respect to the noisy supply terms $f_{st}$. The propositions below are proved in Appendix A.

**Proposition 1.** For all $t < T$, $E_s p_t / \theta > E_s E_t(\theta) / \theta$.

It is only at the final trading date, $T$, that we have $E_s p_T / \theta = E_s E_T(\theta) / \theta$. 

![Graph showing price paths and expectations](https://via.placeholder.com/150)
Main results

- Prices deviate systematically from the average expectation of the fundamental value of the asset.
- Inertia of prices.
- Intuition: Excessive weight assigned to the public signal $y$ and previous prices.
Main results

- For risk neutral traders ($\tau \to \infty$) or infinitely precise signals ($\beta \to \infty$), prices are fully revealing of the fundamental value. This is $p_t \to E_t(\theta) \neq \theta$.

- As investors become very risk averse ($\tau \to 0$), they are less aggressive and prices are less informative. This is $p_t \to q_t$. 
Critiques

- This theory captures the systematic deviation of prices from fundamentals but does not capture one of the striking features of bubbles, their collapse.

- Here bubbles suddenly appear and gradually disappear over time and correct itself.
Abreu and Brunnermeier, Ecta 03: Main ideas

- Rational arbitrageurs may know the price of an asset exceeds the fundamental and still decide not to sell.
- The key is they do not know when the bubble will burst, where it is required a critical mass of speculators to do it.
- Main elements for this to work:
  - Dispersion of opinions among arbitrageurs.
  - Need for coordination.
Abreu and Brunnermeier, Ecta 03: Main ideas

- The bubble ultimately burst.
- We can think also in dispersion of information about whether fundamentals have moved towards a new plateau.
- Irrelevant news may have a huge impact through synchronization and coordination effects.
- Critique: Here the bubble is just assumed, and the goal is to show how it is maintained and then suddenly explodes.
- Joseph Zeira (1999) has a similar story. "Information Bubbles".