Advanced Macroeconomics I

ECON 525a - Fall 2009

Yale University

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Week 5 - Bubbles

Introduction

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

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- 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.