Perfectly Rational Fools’ Bubbles

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Abstract

Many economists are intrigued by bubbles, but reluctant to incorporate them in their models, often due to skepticism about the available theory. In particular, Kindleberger/Minsky ideas on speculative manias are intuitively appealing, but it is unclear whether they are even compatible with rational expectations equilibrium. The well-known Abreu and Brunnermeier (2003; AB) model, rationalizes bubbles as the outcomes of bubble riding games, but features irrational agents and prices that do not always reflect demand. Doblas-Madrid (2012; DM) addresses some of these issues in a rational model with asymmetric information, borrowing constraints, noise, and market timing à la Shapley-Shubik. The latter assumption improves over AB in that prices reflect selling pressure, but remains problematic for two reasons. First, it makes the model difficult to embed in a standard Walrasian macro model. Second, its real world interpretation is implausible, since it would only hold in markets where agents can exclusively submit market orders (and no limit orders) and the duration of each period is very short. In this paper, we take the theory of bubble riding one step forward by showing that noise alone is enough to keep prices from being too revealing. Thus, we can replace the Shapley-Shubik market timing assumption with the much more standard Walrasian market.

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