Adam and Marcet's *Booms and Busts in Asset Prices*

discussion by
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Booms and Busts in Asset Prices

Substantive question:

- What drives the low frequency movements observed in stock markets around the world?

Methodology:

- Model agents that are internally rational.
- Solve a non-linear model under bounded rationality instead of log linearizing around REE and then replace the expectations operator.

What drives booms and busts?

Agents learn about future returns by observing past returns.

- Endogenous reinforcement effect: Higher than expected returns makes agents more optimistic about future returns, increases demand for asset and drives up asset prices, which increases returns...
- ...but when asset prices are expected to increase by enough, agents want to increase consumption sufficiently to reduce asset demand enough to make a negative return surprise almost certain, which leads to lowered return expectations...

A nice and plausible mechanism for both phases of a bubbly episode.

- Model with learning (but not with RE) is consistent with survey evidence that asset price boom around the millennium coincided with high return expectations. How about other REE models?

Methodological contribution, Part I

In full information REE, prices are redundant as a source of information.

- Adam and Marcet: Prices a relevant input into asset demand function when the representative agent does not know that he is representative.
- Seems to accord with how (some) practitioners trade: Estimate stochastic model governing prices and dividends and try to find exploitable correlations

Some alternatives with similar implications:

- Agents fitting different models, and set of models is not common knowledge
- Endow agents with different information sets as in noisy REE literature (e.g. Admati 1985)

Not sure that increased complexity would be justified.

Methodological contribution, Part II

Internal vs external rationality:

- Separating rationality of decisions, given beliefs, from knowledge of how the world works.

I like this a lot.

Open issues:

- Researcher still chooses beliefs of agents.
- What beliefs are reasonable, if we rule out true model? Is there "money lying around on the table"?
- Can we model agents behavior in response to a complex world in a simple model?

As far as I know, nobody has good answers to these questions, but they seem worth thinking about.

Summing up

- Nice paper that provides a plausible explanation of an important phenomenon.
- Pushes the methodological boundaries of the bounded rationality literature.
- But: Some potentially important modeling choices still have to be made by the researcher, and with little theory to guide him.