

Market Breakdown and Indeterminacy under Model Uncertainty

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Abstract

We study a dynamic financial market with model (or "Knightian") uncertainty when agents use the inertia principle proposed by Bewley. We characterize efficient allocations and equilibria in abstract economies. In a second step, we study a mean--variance version of the model where agents face risk as well as (model) uncertainty. We show that trade occurs in the risky part of the market whereas trade in the uncertain assets breaks down when model uncertainty passes a certain threshold. We also show that equilibria with inertia are indeterminate so that equilibrium prices may fluctuate in a certain range around one "focal" equilibrium.

Tuesday, March 6, 2012
Sherrerd Hall 101
4:30 PM