Abstract

The book consists of a collections of papers which develop a new theory of expectations called "rational beliefs." The theory proposes that a crucial component of social risk and economic fluctuations is endogenously propagated by variations in the state of beliefs of market participants. This component is called "Endogenous Uncertainty". The first part of the book explores the structure of general equilibrium models in which market participants hold rational beliefs. It shows that to accommodate endogenous uncertainty, the state space of such models must be expanded to include the "state of belief." The second part of the book studies the structure of volatility in financial markets and explores four well known "paradoxes." It is demonstrated that the presence of endogenous uncertainty under rational beliefs resolves all four paradoxes: the excess volatility of stock returns and of foreign exchange rates, the large realised equity premium on risky assets and the time variability of the variance of asset prices.

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Advances in Economic Theory. Endogenous fluctuations. Fluctuations may be generated by economic shocks that are due either to variations of private sector behavior originating in tastes or technological changes or to stochastic shifts in government policy. Under such an hypothesis, the variables subject to shocks will be modeled as exogenous uncertain parameters.