Asset Market Crashes in the Limit of Speculation

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Abstract

This paper provides a theoretical explanation about the whole process of asset price boom and crashes, especially in non-financial asset markets, like residential real-estate market. I believe this paper will shed a new light on the recent US land market boom and crashes, which has led to the Sub-prime Crises.

Our view can be termed as "spontaneous boom and crash" in short. Boom is sustained by the normal market function itself where price increasingly reflects information. As price reflects more information, opportunity of excess profit gets less and less, till trade cost overwhelms, where market crashes .

Policy implication is that it is difficult to pursue both allocative efficiency and price stability in such asset markets.

In order to form our story, we utilize 3 key ingredients;
1) Heterogeneous valuation,
2) Underestimation of future asset price,
3) Insufficient wealth.

1) lets speculation plays a central role in asset markets, similar to Harrison and Kreps (1978)("Speculative Investor Behavior in a Stock Market with Heterogeneous Expectations", *QJE*, 92, 323-336), 2) makes price reflect information gradually, which explains boom, 3) allows lending behavior reflect into price forming, which invites crash phenomenon.

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