RATIONAL SPECULATIVE BUBBLES: A CRITICAL VIEW

Abstract: The theory of rational bubbles is, no doubt, a part of the important literature developed within the frame of neoclassical postulates of perfectly rational and informed market participants, and it aims to explain the divergences of asset prices from their fundamental value. According to this theory, a bubble is present whenever asset prices progressively diverge from their fundamental value, which happens because agents expect that asset prices will continue to grow exponentially far in the future (self-fulfilling prophecies), thus promising ever larger capital gains. In our opinion, the basic shortcoming of this theory refers to the assumption that all market agents are perfectly informed and rational, and that accordingly, they form homogeneous expectations. The model does not explain the processes of decision-making and expectation formation, and it does not detect potential psychological and institutional factors that might significantly influence decision making and market participants' reactions to news. Since, in our view, the validity of a model is assessed upon its assumptions, we conclude that comprehensiveness of the rational bubble model is, to put it mildly, limited.

Key words: rational speculative bubbles, fundamental value, efficient financial markets, rational expectations, capital gain.

JEL Classification: E12, G14