Speculative bubbles and Crashes: Fundamentalists and Positive-Feedback Trading

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Abstract

We develop and examine a simple heterogeneous agent model in this paper, where the distribution of returns generated from the model has stylized facts: fat tails and volatility clustering. Our results indicate that the relative risk tolerance between fundamentalists and positive-feedback traders determines the path of price fluctuations. Fundamentalists are more able to dominate the market when they are more willing to take risk. In our model fundamentalists most likely cause heavy-tailedness, and positive-feedback traders cause the formation of speculative bubbles. In addition, the risk attitudes of traders vary across time and the general low level of risk bearing of fundamentalists could explain the frequent occurrence of bubbles.

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