ETH
Eidgenössische Technische Hochschule Zürich
Swiss Federal Institute of Technology Zurich

Chair of Entrepreneurial Risks

More hedging instruments may destabilize markets

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Abstract:

This paper formalizes the idea that more hedging instruments may destabilize markets when traders have heterogeneous expectations and adapt their behavior according to experience based reinforcement learning. In a simple asset pricing model with heterogeneous beliefs the introduction of additional Arrow securities may destabilize markets, and thus increase price volatility, and at the same time decrease average welfare. We also investigate whether a fully rational agent can employ additional hedging instruments to stabilize markets. It turns out that the answer depends on the composition of the population of non-rational traders and the information gathering costs for rationality.

Brock, W.A., Hommes, C.H. and Wagener, F.O.O., More hedging instruments may destabilize markets, CeNDEF Working Paper Revised version, February 2009.
(http://www1.fee.uva.nl/cendef/whoiswho/showHP/default.asp?pID=2&selected=pi)

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