In Search of the Origins of Financial Fluctuations: The Inelastic Markets Hypothesis

In this paper, the authors develop a framework to theoretically and empirically analyze the fluctuations of the aggregate stock market. Households allocate capital to institutions, which are fairly constrained, for example operating with a mandate to maintain a fixed equity share or with moderate scope for variation. As a result, the price elasticity of demand of the aggregate stock market is small, so flows in and out of the stock market have large impacts on prices.

Using the recent method of granular instrumental variables, the authors find that investing \$1 in the stock market increases the market's aggregate value by about \$5. They also show that they can trace back the time variation in the market's volatility to flows and demand shocks of different investors.

The authors also analyze how key parts of macro-finance change if markets are inelastic. They show how general equilibrium models and pricing kernels can be generalized to incorporate flows, which makes them amenable to use in more realistic macroeconomic models, and to policy analysis. Their calibration implies that government purchases of equities have a non-trivial impact on prices. Corporate actions that would be neutral in a rational model, such as share buybacks, have substantial impacts too.

The author's framework allows them to give a dynamic economic structure to old and recent datasets comprising holdings and flows in various segments of the market. The mystery of apparently random movements of the stock market, hard to link to fundamentals, is replaced by the more manageable problem of understanding the determinants of flows in inelastic markets. They delineate a research agenda that can explore a number of questions raised by this analysis, and might lead to a more concrete understanding of the origins of financial fluctuations across markets.

actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Diversification does not eliminate the risk of experiencing investment losses.

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