

INFORMATION EQUILIBRIA IN DYNAMIC ECONOMIES

WITH DISPERSED INFORMATION*

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ABSTRACT

We study Rational Expectations equilibria in dynamic models with dispersed information and signal extraction from endogenous variables. Existence and uniqueness conditions for a new class of rational expectations equilibria in economies with dispersed information are established. The novelty of this class lies in the presence of confounding dynamics in the equilibrium process that can permanently sustain information dispersion across agents, even when the equilibrium process is perfectly observed. A feature of the equilibria belonging to this class is a dynamic response of endogenous variables to economic shocks that display waves of optimism and pessimism that are not present in the full information counterpart. We derive an analytical characterization of the equilibria that generalizes the celebrated Hansen-Sargent optimal prediction formula and makes a connection to the well established complete and hierarchical informational setups. The analytical solution permits a closed-form for the higher-order beliefs representation. We show that higher-order beliefs, contrary to recent findings, can generate a positive effect on information diffusion: if dispersedly informed agents were not engaging in formulating expectations about expectations about expectations and so on, information transmission through equilibrium prices would be reduced.

Keywords: Dispersed Information, Incomplete Information, Rational Expectations Equilibrium, Higher-Order Beliefs

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1 INTRODUCTION

Dynamic models with dispersed information are becoming increasingly prominent in several literatures such as asset pricing, optimal policy communication, international finance, and business cycles.¹ The basic idea underlying these models is that dispersed information affects the behavior of economic agents and, therefore, equilibrium outcomes. While the study of how information can influence dynamics has proven fruitful, there are several aspects of this literature that remain underdeveloped. First, the opposite channel, i.e. how the dynamic unfolding of equilibrium variables can alter information, has been essentially left unexplored. We emphasize this channel by defining an “Information Equilibrium,” which formalizes the informational fixed point of a rational expectations equilibrium. Through this channel we uncover an interesting new class of rational expectations equilibria characterized by an under- and overreaction of equilibrium variables. Second, there is scant work in the way of establishing a systematic connection between rational expectations models with dispersed information and models with complete or hierarchical information. We make such a connection by appealing to the Hansen-Sargent optimal prediction formula, and showing how reinterpreting a signal-to-noise ratio in dispersed settings permits a one-to-one mapping to hierarchical informational settings. Finally, we examine higher-order beliefs in models with dispersed information. To the best of our knowledge, this paper is the first to analytically solve for higher-order beliefs in a dynamic setting.

This underdevelopment has plagued the literature for several decades. The role of incomplete information in economic settings was acknowledged very early on by Keynes (1936) and Pigou (1929). Their ideas were first formalized in a rational expectations setting by Lucas (1972, 1975), Townsend (1983) and King (1982). But from this early literature it was immediately clear that solving and characterizing the equilibrium of dynamic models with incomplete information would be challenging. Sargent (1991) and Bacchetta and van Wincoop (2006) attribute the lack of research following the early work of Lucas, King and Townsend to these technical challenges, even though these models harbored much potential. These issues continue to detract from the current literature as many papers resort to the same truncation strategies, numerical approximations, or other simplifications found in Lucas, King and Townsend’s early work in order to solve for and characterize the equilibrium. This paper does not rely on approximations or simplifying assumptions.²

We develop our key existence, uniqueness and characterization results for models with dispersed information in several steps. We do this for two reasons: first, each step has value on its own in terms of possible applications,

¹The literature is too voluminous to cite every worthy paper. Recent examples include: Woodford (2003), Pearlman and Sargent (2005), Allen, Morris, and Shin (2006), Bacchetta and van Wincoop (2006), Hellwig (2006), Adam (2007), Gregoir and Weill (2007), Angeletos and Pavan (2007), Kasa, Walker, and Whiteman (2011), Lorenzoni (2009), Rondina (2009), Angeletos and La’O (2009b), Angeletos and La’O (2011), Hellwig and Venkateswaran (2009), Graham and Wright (2010), Nimark (2011), Hassan and Mertens (2011).

²The emphasis in the current paper is on models with dispersed information but the solution procedure extends to other settings [see, Rondina and Walker (2012b)]. Others, such as Futia (1981), Taub (1989), Kasa (2000), Walker (2007), Rondina (2009), Bernhardt, Seiler, and Taub (2009), have used similar techniques to solve dynamic models with incomplete information structures but none have provided the analytical representations (e.g., higher-order belief dynamics, generalized Hansen-Sargent representations) presented here, nor the systematic treatment of equilibrium conditions in models with dispersed information.

and second, decomposing the key result into steps allows us to obtain some crucial insights when information is dispersed. The key steps are as follows:

We begin by introducing the concept of *confounding dynamics*. Confounding dynamics arise when the realizations of an economic shock over time combine in such a way as to render the exact unraveling of the state impossible, even when an arbitrarily large amount of data is available. That is, we show that when confounding dynamics are present, the observation of the current and past equilibrium variable - the equilibrium price in our model - does not dissolve the information dispersion so that agents remain differentially informed in equilibrium. The dynamic signal extraction undertaken by market participants causes the equilibrium price to display continuously oscillating overpricing and underpricing compared to the price that would emerge under complete information. To the best of our knowledge, this equilibrium dynamic behavior is new to the rational expectations literature.

After defining the concept of an Information Equilibrium, we derive the existence and characterization conditions for the dispersed informational setup (Theorem 1). In this setup, there are a continuum of agents where each agent receives a privately observed noisy signal about the state of the market fundamentals, together with the equilibrium price. We then consider a market setting with two types of agents: perfectly informed and uninformed. We then show that the equilibrium of this market is equivalent to the aggregate representation of the dispersed information case (Theorem 2). The equivalence holds once the parameter measuring the proportion of agents perfectly informed in Theorem 2 is reinterpreted as the signal-to-noise ratio of the privately observed signal of Theorem 1. We interpret Theorem 2 as an aggregation result that allows us to study the aggregate properties of a simpler market setting - the equilibrium with two types of agents - rather than the dispersed information setting. This equivalence result can be understood by thinking about the optimal signal extraction strategy of dispersedly informed agents as a mixed strategy. With some probability agents will act as if their private signal is exactly correct, mimicking thus the behavior of the perfectly informed agents. With the complementary probability they will act as if their private signal contains no information about the state and so they will consider only the information from the equilibrium price, thus mimicking the other fraction of agents. The aggregation result of Theorem 2 allows us to gain important insights into the interaction of information and dynamics in equilibrium and extends naturally to any rational expectations model with dispersed information.

We then turn to characterizing the aggregate and individual-level equilibrium conditions. Corollary 2 derives the relationship between the standard Hansen-Sargent optimal prediction formula when agents have full information, and a generalized version of the prediction formula when agents have dispersed information. The additional terms materialize because uninformed agents must condition down due to confounding dynamics. The extent to which uninformed agents must condition down depends upon the proportion of informed agents in the market. Proposition 1 demonstrates the difference between the aggregate characterization and the individual level characterization in an equilibrium with dispersed information. This proposition shows that the unconditional

cross-sectional variance in beliefs across agents remains non-degenerate in equilibrium. The section concludes by deriving the space of existence for an Information Equilibrium, proving that the equilibria considered here are non-generic and can easily arise in many rational expectations models.

Equipped with the analytical characterization of the market equilibria under dispersed information, we then turn to the characterization of the higher-order beliefs (HOB) and study the role of higher order thinking in shaping endogenous dynamics (Section 5). Recent papers have emphasized the role of HOB dynamics and the subsequent breakdown in the law of iterated expectations with respect to the average expectations operator in models with asymmetric information [e.g., Allen, Morris, and Shin (2006), Bacchetta and van Wincoop (2006), Nimark (2011), Pearlman and Sargent (2005), Angeletos and La'O (2009a)]. Many resort to numerical analysis or truncation of the state space in demonstrating the dynamic case, making it difficult to isolate the specific role played by HOBs. With an analytical solution in hand, we are able to characterize these objects in closed form (Proposition 2). In addition, we relate the formation of HOBs to the transmission of information in equilibrium by showing that the formation of HOBs increases the information impounded into endogenous variables (Corollary 3). This, in turn, leads to a decrease in the variance of prediction errors. In other words, forming HOBs gives rise to a positive effect on information diffusion. This conclusion goes against the existing conjecture that HOBs are responsible for the slow reaction of endogenous variables to structural shocks. This idea stems from the observation that agents forming HOBs forecast the forecast errors of uninformed agents, thereby injecting additional persistence through the higher-order expectations. However, we find that this observation is incomplete as it does not take into account the effect of higher order thinking upon informational transmission. Once the both effects are considered, the latter one always dominates in our setting, and thus HOB formation *always* improves information in equilibrium, which in turn actually *reduces* the persistence in equilibrium.

In order to make the derivation of our results as transparent as possible, we focus on a simple forward-looking asset pricing framework. But it is important to note that such a framework is, nonetheless, flexible enough to encompass the key dynamic equations of many standard dynamic models with incomplete information. Our results and methods are therefore generally applicable to any dynamic model of higher economic complexity (e.g., see Rondina and Walker (2012a) for an application of our methods to a standard real business cycle model). Moreover we argue, through a series of examples, that standard diffusion processes are natural stochastic processes for studying confounding dynamics. Given that diffusion processes are well founded empirically and standard in many dynamic stochastic general equilibrium models, extending our methodology and results to other areas is straightforward.

2 INFORMATION EQUILIBRIUM: PRELIMINARIES

This section establishes notation and lays important groundwork for interpreting the equilibrium characterizations that follow.

2.1 EQUILIBRIUM MODEL To fix notation and ideas, we define an information equilibrium within a generic linear rational expectations framework. The forward-looking nature of the key equilibrium relationship is quite flexible in that it allows for a broad range of interpretation, so that our results apply to any setting where current variables depend on the expectations of future variables.

2.1.1 MARKET In order to keep things grounded in a specific economic example, we interpret our equations as arising from the perfectly competitive equilibrium of an asset market in which investors take positions on a risky asset to maximize the expected utility of next period wealth.³ The asset market works as follows: investors submit their demand schedules—a mapping that associates the asset price to net demand—to a Walrasian auctioneer. The auctioneer collects the demand schedules and then calls the price that equates demand to supply. To allow for trading in equilibrium, the net supply of the asset in a given period t , s_t , is assumed to be exogenous.⁴ The net demand in the asset market is provided by a continuum of potentially diversely informed agents indexed by i . The market clearing price chosen by the Walrasian auctioneer is given by

$$p_t = \beta \int_0^1 \mathbb{E}_t^i p_{t+1} \phi(i) di + s_t \tag{2.1}$$

where $\beta \in (0, 1)$, \mathbb{E}_t^i is the conditional expectation of agent i , $\phi(\cdot)$ is the density of agents and the exogenous process (s_t) is driven by a Gaussian shock

$$s_t = A(L)\varepsilon_t, \quad \varepsilon_t \stackrel{iid}{\sim} N(0, \sigma_\varepsilon^2) \tag{2.2}$$

and where $A(L)$ is assumed to be a square-summable polynomial in non-negative powers of the lag operator L .

2.1.2 INFORMATION Information is assumed to originate from two sources—exogenous and endogenous. Exogenous information, denoted by U_t^i , is that which is not affected by market forces and is endowed by the modeler to the agents. Thus, the exogenous information profile $\{U_t^i, i \in [0, 1]\}$ is a primitive of the model. Endogenous information is generated through market interactions. When agents are diversely informed, endogenous variables may convey additional information not already contained in the exogenous information set. We separate endogenous information into two components— $\mathbb{V}_t(p)$ and $\mathbb{M}_t(p)$. The notation $\mathbb{V}_t(p)$ denotes the smallest linear closed

³In Appendix B we present a simple asset demand model that delivers the equilibrium equation that we use throughout the paper.

⁴In what follows we will let the supply of the asset be measured by $-s_t$. Therefore, an increase (decrease) in s_t will correspond to a decrease (increase) in the exogenous supply of the asset.

subspace that is spanned by current and past p_t , we refer to it as “time-series information” of p_t . $\mathbb{M}_t(p)$, on the other hand, results from the assumption that agents know the equilibrium process p_t evolves according to (2.1); we refer to it as “*information from the model*.”

To clarify what information is captured in $\mathbb{M}_t(p)$, it is useful to think about how the the knowledge of the model (2.1) affects the Walrasian market structure described above. When rational investors formulate the demand schedule to submit to the Walrasian auctioneer, they know that the auctioneer will pick a price that clears the market, i.e. that satisfies (2.1). Investors can use this information to reduce their forecast errors. To see this, suppose that all the investors have the same information and thus the individual demand schedule is given by $\beta\mathbb{E}_t p_{t+1} - p_t$, for some arbitrary information set. Given a candidate price p_t chosen by the auctioneer, investors know that at that price the market will clear, which means $\beta\mathbb{E}_t p_{t+1} - p_t + s_t = 0$. If this is the case, then investors will treat s_t as part of the information that they should use to derive $\mathbb{E}_t p_{t+1}$ for any arbitrary p_t . As investors submit their demand schedules they do not know what is the true value of s_t but they can formulate expectations that are consistent with the true value that will be revealed once the Walrasian auctioneer picks the market clearing price. If investors ignored this information, they would incur consistently higher forecast errors, which would violate rational expectations and imply their submitted demand schedules were not optimal. That subjective beliefs must be model consistent is a standard definition of a rational expectations equilibrium.⁵ In rational expectations models with complete information and representative agents, information from the model is a trivial equilibrium condition. We show below that in models with incomplete information and heterogeneously informed agents, information from the model plays a crucial role in determining equilibrium.

The time t information of trader i is then $\Omega_t^i = U_t^i \vee \mathbb{V}_t(p) \vee \mathbb{M}_t(p)$, where the operator \vee denotes the span (i.e., the smallest closed subspace which contains the subspaces) of the U_t^i , $\mathbb{V}_t(p)$ and $\mathbb{M}_t(p)$ spaces.⁶ Uncertainty is assumed to be driven entirely by the Gaussian stochastic process ε_t , which implies that optimal projection formulas are equivalent to conditional expectations,

$$\mathbb{E}_t^i(p_{t+1}) = \Pi[p_{t+1} | \Omega_t^i] = \Pi[p_{t+1} | U_t^i \vee \mathbb{V}_t(p) \vee \mathbb{M}_t(p)]. \quad (2.3)$$

where Π denotes linear projection. The normality assumption also rules out sunspots and implies the equilibrium lies in a well-known Hilbert space, the space spanned by square-summable linear combinations of ε_t .

2.1.3 EQUILIBRIUM DEFINITION

We now define an information equilibrium.

⁵From a mere statistical point of view, the knowledge of the model is equivalent to the knowledge of the covariance generating function between the process s_t and the equilibrium price p_t . In other words, in equilibrium there is a true relationship between prices and supply that is summarized by the variance-covariance generating matrix $\begin{pmatrix} g_{pp}(z) & g_{ps}(z) \\ g_{ps}(z) & g_{ss}(z) \end{pmatrix}$. Knowledge of the model corresponds to knowing $g_{ps}(z)$ and using it to obtain s_t from p_t .

⁶If the exogenous and endogenous information are disjoint, then the linear span becomes a direct sum. We use similar notation as Futia (1981) in that $\mathbb{V}_t(x) = \mathbb{V}_t(y)$ means the space spanned by $\{x_{t-j}\}_{j=0}^{\infty}$ is equivalent, in mean square, to the space spanned by $\{y_{t-j}\}_{j=0}^{\infty}$.

Definition IE. An *Information Equilibrium (IE)* is a stochastic process for $\{p_t\}$ and a stochastic process for the information sets $\{\Omega_t^i, i \in [0, 1]\}$ such that: (i) each agent i , given the price and the information set, optimally forms expectations according to (2.3); (ii) p_t satisfies the equilibrium condition (2.1).

An IE consists of two objects, a *price* and a *distribution of information*, and can be summarized by two statements: (a) given a distribution of information sets, there exists a market clearing price determined by each agent i 's optimal prediction conditional on the information sets; (b) given a price process, there exists a distribution of information sets generated by the price process that provides the basis for optimal prediction. Both statements (a) and (b) must be satisfied by the same price and the same distribution of information *simultaneously* in order to satisfy the requirements of an IE.

2.2 CONFOUNDING DYNAMICS AND SIGNAL EXTRACTION Central to the existence of the class of rational expectations equilibria examined in this paper is the idea that dynamics can conceal information. In this section we lay some groundwork on the relationship between the dynamics of a stochastic process and the information conveyed by that process. We isolate a signal extraction mechanism that operates at the heart of the new class of equilibria established in Section 3; this will allow us to gain insights in the interpretation of the equilibrium dynamics.

In dynamic settings, the information set of agents is continuously expanding as they collect new observations with each period t . A crucial question in such settings is whether an expanding information set over time corresponds to an ever increasing precision of information about the current and past structural innovations, $\{\varepsilon_{t-j}\}_{j=0}^{\infty}$.

The answer to this question depends upon the characteristics of the observed variables. Using the terminology of Rozanov (1967), if the structural innovations are *fundamental* for the observable variables, then agents would eventually learn the true underlying dynamics. Intuitively, if a dynamic stochastic process is invertible in current and past observables, then it is fundamental and the observed history would allow one to back out the exact history of the underlying fundamental innovations. On the other hand, if the process is non-fundamental, then the observed history will contain only imperfect information about the fundamentals. In this case we say that the observed variable displays *confounding dynamics*. In linear dynamic settings, confounding dynamics can be formalized by non-fundamental moving averages representations.

As an example, consider the problem of extracting information about ε_t from

$$x_t = -\lambda\varepsilon_t + \varepsilon_{t-1}. \tag{2.4}$$

If $|\lambda| \geq 1$, the stochastic process x_t is invertible in current and past x_t , which means that there exists a linear

combination of current and past x_t 's that allows the exact recovery of ε_t ; formally

$$\mathbb{E}(\varepsilon_t | x^t) = -1/\lambda (x_t + \lambda^{-1}x_{t-1} + \lambda^{-2}x_{t-2} + \lambda^{-3}x_{t-3} + \dots) = \varepsilon_t. \quad (2.5)$$

Note that the infinite sum converges as λ^{-j} goes to zero for j "big enough."

When $|\lambda| < 1$ the process is no longer invertible in current and past x_t . Equation (2.5) is no longer well defined as the coefficients for the past realizations of x_t grow without bound. Nevertheless, there is still a linear combination of x_t that minimizes the forecast error for ε_t ; this is given by

$$\mathbb{E}(\varepsilon_t | x^t) = -\frac{\lambda}{|\lambda|} (x_t + \lambda x_{t-1} + \lambda^2 x_{t-2} + \lambda^3 x_{t-3} + \dots) = \tilde{\varepsilon}_t. \quad (2.6)$$

Non-invertibility implies that $\tilde{\varepsilon}_t$ contains strictly less information than ε_t , in the sense that the mean squared forecast error conditional on $\tilde{\varepsilon}_t$ is bigger than ε_t (which is identically zero). More specifically, the mean square forecast error is

$$\mathbb{E}[(\varepsilon_t - \tilde{\varepsilon}_t)^2] = (1 - \lambda^2) \sigma_\varepsilon^2 > 0.$$

The mean squared forecast error approaches zero as the process becomes invertible, i.e. as $|\lambda| \rightarrow 1$ from below.

The imperfect information described by (2.4) when $|\lambda| < 1$ corresponds to an ignorance about the initial state of the world at time $t = 0$ that *never* unravels because of the confounding dynamics of x_t . Imagine that agents initially observe $x_1 = -\lambda\varepsilon_1 + \varepsilon_0$ and thus cannot distinguish between ε_1 and ε_0 . If they knew ε_0 they could easily back out ε_1 from x_1 and then, as information about x_t accumulates, all the values of ε_t for $t > 1$ would be known. However, if all agents observe is x_0 , then the best they can do is to get as close as possible to ε_t using (2.6). Whereas in standard signal extraction problems the informational friction is assumed in the form of a superimposed signal-to-noise ratio, in (2.4) the noise is a result of the dynamic unfolding parameterized by λ that keeps the ignorance about the initial state ε_0 informationally relevant at any point in time.⁷

An additional important implication of confounding dynamics is that optimal learning of the agents creates a persistent effect of past innovations. Let $\lambda < 0$ and rewrite (2.6) as

$$\begin{aligned} \tilde{\varepsilon}_t &= \underbrace{-\lambda\varepsilon_t}_{\text{information}} + \underbrace{(1 - \lambda^2)[\varepsilon_{t-1} + \lambda\varepsilon_{t-2} + \lambda^2\varepsilon_{t-3} + \dots]}_{\text{noise from confounding dynamics}}. \end{aligned} \quad (2.7)$$

This equation clarifies how λ controls the information that the history of x_t contains about ε_t through two channels: an informative signal with weight λ (the first term on the RHS), and a noise component with weight

⁷As long as $|\lambda| < 1$, whether λ is positive or negative does not matter for the informational content. In Appendix B we show that the signal extraction problem under confounding dynamics is equivalent, in forecast mean square error terms, to a standard signal extraction problem when $\lambda^2 = \tau$, where τ is the signal-to-noise ratio of a standard signal extraction problem. The interested reader is directed to Appendix B for details.

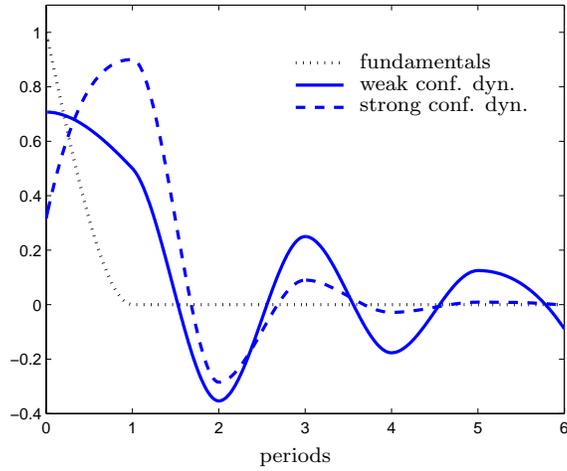


Figure 1: Impulse response of the optimal prediction formula for fundamentals ε_t in presence of confounding dynamics (Equation (2.7)) to a one time innovation $\varepsilon_0 = 1$. The dotted line is the process for fundamentals; the solid line is the response under “weak” confounding dynamics ($|\lambda| = 1/\sqrt{2}$); the dashed line is the response under “strong” confounding dynamics ($|\lambda| = 1/\sqrt{11}$).

$(1 - \lambda^2)$. Notice that the noise term is a linear combination of past innovations, which is the source of the persistent effect of past innovations. As the confounding dynamics become more pronounced, i.e. when λ decreases, there are three effects. First, the weight on the informative signal decreases as x_t contains less information about ε_t . Second, the weight $(1 - \lambda^2)$ on the noise increases; however, this increase is in part offset by the third effect, which is a reduction in the persistence of innovations dated $t - 2$ and earlier.

To visualize these effects, we report the impulse response function for the prediction equation (2.7) to a one time, one unit increase in ε_t in Figure 1 for both a low and a high value of λ with $\lambda < 0$.⁸ First notice that for the high- λ case, the value of $\mathbb{E}(\varepsilon_t|x^t)$ is very close to the true innovation value of 1 on impact, whereas for the low- λ case, the underestimation is quite large. Second, in both cases the current innovation will persistently affect the prediction function several periods beyond impact. This is in contrast to the full information case where the impulse response is zero after impact (fundamentals). However for the weak confounding dynamics, the effect will be initially weaker and then it will only slowly decay. For strong confounding dynamics, the opposite is true: the effect is initially stronger and the decay is subsequently faster.

⁸We chose the case of $\lambda < 0$ because the resulting exogenous process lends itself to a meaningful economic interpretation. In fact, later we will use a process similar to (2.4) to model a canonical S-shaped diffusion process. The prediction formula with $\lambda > 0$ would display the same response at impact but it would not exhibit the oscillatory pattern of Figure 1. Instead, the impulse response would turn negative at period 2 and gradually approach zero from below from then onward. The three effects described above will all still be present, nonetheless.

3 INFORMATION EQUILIBRIA: MAIN THEOREM

This section establishes the main result of the paper: the existence of a new class of rational expectations equilibria for dynamic economies with dispersed information and a characterization that can be applied to any dynamic model with dispersed information. We begin by presenting the full information solution to the equilibrium model (2.1) and then we state the main theorem of the paper.

3.1 FULL INFORMATION BENCHMARK We define Full Information as the case when every buyer is endowed with perfect knowledge of the innovations history up to time t . Formally

$$U_t^i = \mathbb{V}_t(\varepsilon), \forall i \in [0, 1]. \quad (3.1)$$

Here, and in the following analysis, we assume that agents always observe the endogenous information $\mathbb{V}_t(p) \vee \mathbb{M}_t(p)$. Under full information all the buyers will have the same information in equilibrium and so (2.1) can be written as the contemporaneous expectation of the discounted sum of future s_t 's,

$$p_t = \sum_{j=0}^{\infty} \beta^j \mathbb{E}_t(s_{t+j}). \quad (3.2)$$

The solution of this model is well known and the equilibrium takes the form

$$p_t = \left[\frac{LA(L) - \beta A(\beta)}{L - \beta} \right] \varepsilon_t \quad (3.3)$$

which is the celebrated Hansen-Sargent formula [Hansen and Sargent (1991)]. Provided $|\beta| < 1$, equation (3.3) is the *unique* Information Equilibrium solution to (2.1) when information is specified as (3.1).

3.2 DISPERSED INFORMATION EQUILIBRIUM The principal case of interest is one in which agents are endowed with dispersed information about the economic fundamentals, while they still observe the current and past history of equilibrium prices. This case captures the informational setup of most of the recent literature on equilibrium models with dispersed information.⁹ Our theorem therefore presents a class of rational expectations equilibria that can easily emerge in such models, but that have not been characterized so far. The theorem also provides useful decompositions that can be directly applied to existing work.

In line with the dispersed information literature, we assume that all agents are identical in terms of the imperfect quality of information they possess. In particular, we assume each agent observes their own particular “window” of the world, as in Phelps (1969). Information is dispersed in the sense that, although complete

⁹The informational setup of this section is especially common in the recent and fast growing literature on dispersed information and the business cycle; see, for example, Angeletos and La’O (2009b), Hellwig and Venkateswaran (2009), Lorenzoni (2009), Maćkowiak and Wiederholt (2007) and Rondina and Walker (2012a).

knowledge of the fundamentals is not given to any one agent, by pooling the noisy signals across all agents it is possible to recover the full information about the state of the economy. The information set is formalized as follows. Consider a set of i.i.d. noisy signals specified as

$$\varepsilon_{it} = \varepsilon_t + v_{it} \quad \text{with } v_{it} \stackrel{iid}{\sim} N(0, \sigma_v^2) \quad \text{for } i \in [0, 1]. \quad (3.4)$$

We assume that agents, in addition to observing the current and past realization of equilibrium prices, are endowed with the exogenous information

$$U_t^i = \mathbb{V}_t(\varepsilon_i) \quad \text{for } i \in [0, 1]. \quad (3.5)$$

The information set of an individual agent i can thus be written as

$$\Omega_t^i = \mathbb{V}_t(\varepsilon_i) \vee \mathbb{V}_t(p) \vee \mathbb{M}_t(p) \quad (3.6)$$

The following Theorem characterizes the equilibrium under dispersed information.

Theorem 1. *Let $\tau \equiv \sigma_\varepsilon^2 / (\sigma_v^2 + \sigma_\varepsilon^2)$ be the signal-to-noise ratio associated with the signal ε_{it} in (3.4). Under the information assumption (3.6), a unique Information Equilibrium for (2.1) with $|\beta| < 1$ always exists and is determined as follows. Suppose that exactly one scalar $|\lambda| < 1$ can be found such that*

$$A(\lambda) - \frac{\tau\beta A(\beta)(1 - \lambda\beta)}{\lambda - (1 - \tau(1 - \lambda^2))\beta} = 0 \quad (3.7)$$

then the information equilibrium price is given by

$$p_t = \frac{1}{L - \beta} \left[LA(L) - \beta A(\beta) \frac{h(L)}{h(\beta)} \right] \varepsilon_t \quad (3.8)$$

with

$$h(L) \equiv \tau\lambda + (1 - \tau) \left(\frac{\lambda - L}{1 - \lambda L} \right). \quad (3.9)$$

If such a scalar $|\lambda| < 1$ cannot be found, then the information equilibrium price is given by (3.3).

Proof. See Appendix A. □

The theorem contains two fixed point conditions, which coincides with our definition of an Information Equilibrium (Definition IE): one that characterizes the information set, (3.7), and one that characterizes the equilibrium price, (3.8). Providing economic intuition and developing a deep understanding of these two equations is the sole purpose of the rest of the paper. Foreshadowing results, we show how (3.7) relates to the agents' information sets and, in

particular, to knowledge of the model. We also derive a one-to-one mapping between this economy and one in which information is hierarchical. This mapping delivers an aggregation result that further enhances economic intuition. Notice also that the equilibrium price takes the form of a generalized Hansen-Sargent formula, with the term $\frac{h(L)}{h(\beta)}$ representing the departure from the standard formula of equation (3.3). In Section 4 we show that the term $h(L)$ emerges from the consideration that agents use the knowledge of the model, together with the history of the equilibrium price, to infer what is the market forecast of future prices.

However before proceeding to this analysis, we first want to argue that these information equilibria are empirically interesting objects by asking the question: How different is the equilibrium price of equation (3.8) from the full information price? Figure 2 reports the impulse response to a one time innovation in the fundamental process ε_t of the equilibrium price characterized in Theorem 1 when primitives of the model are such that a $|\lambda| < 1$ satisfying (3.7) can be found compared to the full information benchmark. The process for the economic fundamental is specified as $A(L) = \frac{1+\theta L}{1-\rho L}$, with $\theta = \sqrt{11}$ and $\rho = 0.9$, so that the effect of an innovation peaks after one period. The rest of the parameter values are set to $\beta = 0.9$ and $\tau = 0.02$. The full information equilibrium is given by plugging these numbers into equation (3.3).

As shown in figure 2, the full information price strongly reacts at impact by taking into account that the shock is persistent and will therefore affect the equilibrium price over the next several periods through its effect on the predictability of future price realizations. The effect will peak after one period and then decay monotonically. The behavior of the full information price essentially amplifies the behavior of the economic fundamentals through the forward looking nature of the equilibrium price equation.

The solid line represents the information equilibrium price of equation (3.8), with equation (3.7) providing the endogenous value for λ of -0.47 . The information equilibrium price displays the confounding dynamics of section 2.2; in addition agents have noisy signals about the innovation and so they are not able to infer the value of the economic fundamentals. As a consequence they will under-react, roughly by 50% compared to the full information case. In the following period, as new information becomes available through the equilibrium price, agents realize that an innovation occurred, but because they initially under-reacted, they now infer from the equilibrium price that the innovation is larger than the actual value. This results in a very optimistic view of the fundamentals and an over-reaction of the equilibrium prices, of about 25% of the full information counterpart. In the subsequent period, observing the equilibrium price agents will think that they have over-estimated the innovation and they will adjust their expectations downward, now again erring on the downside, causing the equilibrium price to under-react by 10% with respect to full information. As the over- and under-reactions subside, the equilibrium price response gets closer to the full information case. It is important to emphasize that this over- and under-reaction is optimal. Agents are fully rational and yet from the perspective of the true economic fundamentals, the market price presents what looks like waves of “optimism” and “pessimism” with respect to the full information benchmark. Given that many empirical time series (e.g., asset prices, business cycles) follow boom-bust cycles,

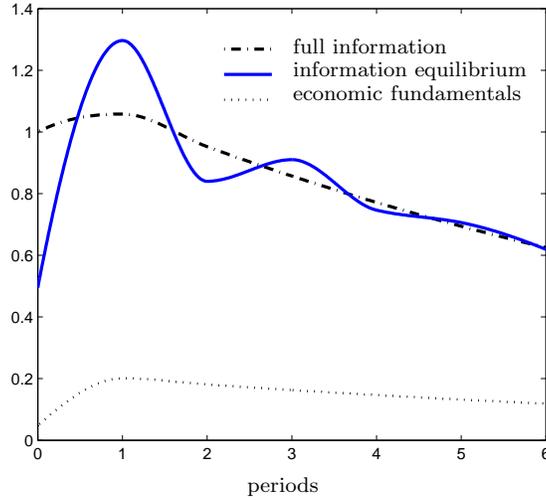


Figure 2: Impulse response of the full information price, the information equilibrium price of Theorem 1, and the process for economic fundamentals $s_t = 0.9s_{t-1} + \varepsilon_t + \sqrt{11}\varepsilon_{t-1}$. The parameter values are $\beta = 0.9$ and $\tau = 0.02$.

we view the information equilibrium as a very interesting departure from the standard equilibrium.

4 INFORMATION EQUILIBRIA: CHARACTERIZATION

4.1 EQUIVALENT REPRESENTATION In order to develop intuition for Theorem 1, we begin by stating a powerful aggregation result and deriving an equivalence to an alternative information structure where instead of considering a continuum of agents with dispersed information, we assume that there are two types of buyers: fully informed and uninformed. The fully informed buyers observe the entire history of economic fundamentals ε up to time t ; the uninformed buyers observe only the entire history of prices up to time t . The proportion of the fully informed buyers is denoted by $\mu \in [0, 1]$, and, consequently the proportion of the uninformed buyers is $1 - \mu$. More formally, we consider a market with the following exogenous information structure:

$$U_t^i = \mathbb{V}_t(\varepsilon) \text{ for } i \in \mu \text{ and } U_t^i = \{0\} \text{ for } i \in 1 - \mu. \quad (4.1)$$

Note that under this informational assumption, the market equilibrium equation (2.1) can be written as

$$p_t = \beta [\mu \mathbb{E}_t^{\mathcal{I}}(p_{t+1}) + (1 - \mu) \mathbb{E}_t^{\mathcal{U}}(p_{t+1})] + s_t. \quad (4.2)$$

where \mathcal{I} is notation for the *fully informed*, while \mathcal{U} is notation for the *uninformed*. The following theorem states the equivalence result.

Theorem 2. *Under the exogenous information assumption (4.1), a unique Information Equilibrium for (4.2)*

with $|\beta| < 1$ always exists and is equivalent to the equilibrium characterized in Theorem 1 with $\tau \equiv \mu$.

Proof. See Appendix A. □

The theorem states that in terms of the aggregate characterization of the equilibrium, the dispersed information setup is identical (i.e., same existence condition (3.7) and same equilibrium pricing function (3.8)) to the hierarchical information setup when the signal-to-noise ratio $\tau \equiv \sigma_\varepsilon^2 / (\sigma_v^2 + \sigma_\varepsilon^2)$ is equal to the proportion of informed traders, μ . This equivalence result can be understood by thinking of the strategic behavior of the dispersedly informed buyers of Theorem 1. Each agent i receives a privately observed signal ε_{it} and a publicly observed signal p_t about the unobserved fundamental ε_t . The optimal behavior—in terms of forecast error minimization—is for the agent to act *as if* the signal ε_{it} contained no noise and thus was equal to the true state ε_t , in measure proportional to the informativeness of the signal τ . At the same time, it is certainly possible that the signal is pure noise and thus it would be optimal to ignore it and act just upon the public signal p_t , this in measure $(1 - \tau) = \sigma_v^2 / (\sigma_v^2 + \sigma_\varepsilon^2)$. Thus, in a dispersed information setting each agent behaves optimally by employing a “mixed” strategy approach: act as if they possess the full information of the informed buyers \mathcal{I} of Theorem 2 with probability τ , and act as if they possess just the public information of the uninformed buyers \mathcal{U} of Theorem 2 with probability $1 - \tau$. Theorem 2 shows that the equilibrium price of a market with μ fully informed and $1 - \mu$ fully uninformed buyers displays, in the aggregate, the mixed strategies of the individual buyers in the dispersed information environment. Theorem 2 is an aggregation result that allows one to study a market with only two representative buyers, one with full information in measure τ and one with just public information in measure $1 - \tau$, knowing that the aggregate behavior of that market is equivalent to the aggregate behavior of a market with dispersedly informed (i.e. heterogeneous) buyers. We will make extensive use of this result when studying the aggregate properties of the equilibrium.

4.2 INFORMATIONAL FIXED POINT The informational fixed point condition (3.7) lies at the heart of the existence of an equilibrium with confounding dynamics. In this section we explore this condition and show under which economically relevant environments it can emerge. We argue that, even in a simple one-equation model like the one used in our analysis, condition (3.7) is easily obtained.

The following is a useful corollary to both Theorems 1 and 2 that helps in understanding the source of the confounding dynamics.

Corollary 1. *Let $\tau \rightarrow 0$ (or, equivalently, $\mu \rightarrow 0$), a unique Information Equilibrium for (2.1) with $|\beta| < 1$ always exists and is determined as follows: Suppose that exactly one scalar $|\lambda| < 1$ can be found such that*

$$A(\lambda) = 0, \tag{4.3}$$

then the information equilibrium price process is

$$p_t = \frac{1}{L - \beta} \left[LA(L) - \beta A(\beta) \frac{\mathcal{B}_\lambda(L)}{\mathcal{B}_\lambda(\beta)} \right] \varepsilon_t \quad (4.4)$$

where $\mathcal{B}_\lambda(L) = \frac{L-\lambda}{1-\lambda L}$. If condition (4.3) does not hold for $|\lambda| < 1$, then the Information Equilibrium is given by (3.3).

Proof. See Appendix A. □

Condition (4.3) offers an important insight into the existence condition (3.7) in Theorem 1. It stipulates that, in order for the equilibrium price to display confounding dynamics, as the informativeness of the signal goes to zero (or equivalently as the proportion of informed traders goes to zero), the supply process s_t must also possess confounding dynamics with respect to the structural innovations, ε_t . To see this more clearly, note that the supply process can be written as $s_t = (L - \lambda)\hat{A}(L)\varepsilon_t$ —where $\hat{A}(L)$ has no zeros inside the unit circle—to satisfy (4.3). This supply process will contain the confounding dynamics described in section 2.2.

The key intuition behind this restriction and the existence condition (3.7) comes from the agents' knowledge of the model, $\mathbb{M}_t(p)$. This concept gets at the idea that in a rational expectations framework agents know that the price that clears the market must satisfy (2.1). Investors will use this information to reduce their forecast errors. Specifically as $\tau \rightarrow 0$, all agents will rationally believe that all market participants will have the same expectations about next period's price in equilibrium. Therefore whatever this expectation is, they know that it must satisfy

$$p_t - \beta \mathbb{E}_t(p_{t+1}) = s_t. \quad (4.5)$$

Recall that as $\tau \rightarrow 0$, only the public signal, p_t , is available to traders at t . Knowledge of the model implies that the left-hand side of (4.5) is in the information set of the traders, and therefore the entire history of s_t must also be contained in the information set of all the agents in equilibrium, i.e. $\mathbb{M}_t(p) = \mathbb{V}_t(s)$. This suggests that in order for confounding dynamics to exist in equilibrium, the s_t itself must display such dynamics, which is exactly what condition (4.3) states.¹⁰ In a simple representative agent economy, imposing confounding dynamics on the exogenous process is sufficient to generate *endogenous* confounding dynamics in equilibrium. The model's cross-equation restrictions ensure that endogenous variables will inherit the stochastic properties of the exogenous variables—confounding dynamics in this case.

In dynamic models with asymmetrically informed agents, conditions that guarantee agents remain heterogeneously informed in equilibrium (i.e., conditions which preserve confounding dynamics) are more difficult to

¹⁰The reasoning behind the result presupposes that all the agents at time t have access to the entire history of their expectations. If this was not the case, which for example could happen if one were to consider an overlapping generation structure of the market where a generation of agents is born in each period and dies the next period, then the new generation would only be able to observe the current realization of s_t and so the information equilibrium might not coincide with the one characterized by (4.4).

derive and not easily interpretable, as evidenced by (3.7). However, the intuition behind knowledge of the model concept provides an unified way to proceed.¹¹

Consider the case of Theorem 2 with $\mu > 0$. Condition (3.7) gives the condition that must hold for the uninformed agents to remain uninformed in equilibrium. Through knowledge of the model, the uninformed buyers will recognize that in equilibrium the following relationship must hold

$$p_t - \beta(1 - \mu)\mathbb{E}_t^{\mathcal{U}}(p_{t+1}) = \beta\mu\mathbb{E}_t^{\mathcal{I}}(p_{t+1}) + s_t. \quad (4.6)$$

The difference between this existence condition and that of Corollary 1 is that the uninformed buyers are not able to back out the exact process for s_t given the history of prices and uninformed predictions, $\mathbb{E}^{\mathcal{U}}$. However, they are able to uncover the sum of the supply process s_t and the predictions of the fully informed buyers $\mathbb{E}^{\mathcal{I}}$. The question is whether this sum displays confounding dynamics that can be inherited by the equilibrium price. Condition (3.7) provides the answer to this question. Appendix A shows that (3.7) is equivalent to the right-hand side of (4.6) evaluated at λ . If this term vanishes at $|\lambda| < 1$, then the sum of the informed agents' expectation and the supply process has a non-fundamental moving average representation and is not invertible with respect to the information set of the uninformed agents. In other words, condition (3.7) implies the right-hand side of (4.6) will display confounding dynamics. Consequently the uninformed agents will only be able to see the sum but not the individual components of the sum. It is in this sense that models with disparately informed agents lead to *endogenous* signal extraction. Uninformed agents want to disentangle the effects on the equilibrium price of the informed agent's expectations from the supply process, but if (3.7) holds, they cannot.

The above intuition is useful in interpreting the existence condition for the dispersed information case. When $\tau > 0$, knowledge of the model under dispersed information results in agents being able to infer the sum of the supply process s_t and the difference between the average market expectations $\bar{\mathbb{E}}$ and their individual expectations, namely

$$p_t - \beta\mathbb{E}(p_{t+1}|\varepsilon_i^t, p^t) = \beta \left[\int_0^1 \mathbb{E}(p_{t+1}|\varepsilon_i^t, p^t) di - \mathbb{E}(p_{t+1}|\varepsilon_i^t, p^t) \right] + s_t \quad (4.7)$$

The informational fixed point in Theorem 1 ensures that the process on the right hand side displays confounding dynamics for the information set (ε_{it}, p_t) , so that, in equilibrium, knowledge of the model does not perfectly reveal the fundamental innovation ε_t .

Since condition (3.7) lies at the core of Theorem 1 it is important to ask whether it holds in economically relevant situations. Indeed, confounding dynamics can emerge in many interesting settings. For example, diffusion processes, such as the adoption of a new technology, normally display confounding dynamics. The diffusion pattern

¹¹In a companion paper, Rondina and Walker (2012b) show that this concept overturns non-existence results thought to be pervasive in models with heterogeneously informed agents.

takes the typical “S” shape: an initial phase of low diffusion, a steep middle diffusion phase and final leveling-off phase [see Rogers (2003)]. Following Canova (2003), a diffusion process where an initial shock ε_t diffuses with the canonical “S” shape can be formalized by

$$s_t = s_{t-1} + \alpha\varepsilon_t + 2\alpha\varepsilon_{t-1} + .75\alpha\varepsilon_{t-2}, \quad (4.8)$$

with $0 < \alpha < 1$. The diffusion process (4.8) displays confounding dynamics.¹² For example, with $\beta = .5$, letting $\tau = 0$ Corollary 1 would then ensure that an information equilibrium is given by (4.4) with $\lambda = -2/3$, whereas, letting $\tau = .01$, Theorem 1 would ensure that an information equilibrium is given by (3.8) with $\lambda = -.7$.

One additional concern about (3.7) is that it could hold only for a combination of parameter values with measure zero, i.e. it could be a non-generic condition. This is clearly not the case. For simplicity consider the limiting condition (4.3). The equilibrium of the corollary is generic because $|\lambda|$ can be *anywhere* inside the unit circle, and $A(\lambda) = 0$ is the *only* restriction placed on $A(\cdot)$. The same argument can be immediately extended to (3.7) by continuity. This suggests that interesting information equilibria can easily emerge from standard rational expectations models. For example, from the diffusion process in (4.8) one can safely change the parameters along several dimensions without affecting the existence of a $|\lambda|$ satisfying (3.7) in Theorem 1. We provide additional examples of the non-generic behavior of the information equilibrium below.

4.3 AGGREGATE CHARACTERIZATION Equipped with the results of Theorems 1 and 2 we turn now to the study of the properties of the price in an information equilibrium. We first notice that the price function in all the Theorems takes the form of a modified Hansen-Sargent formula (3.3). The Hansen-Sargent formula essentially represents an operator that “conditions down” from the full history of innovations (past, present and future) to a linear combination of innovations by subtracting off what is not contained in the information set of the agents. Corollary 2 formalizes the idea.

Corollary 2. *Under the assumptions of Theorem 2, if $|\lambda| < 1$ satisfying (3.7) exists, the information equilibrium price can be written as*

$$p_t = \left(\frac{LA(L)}{L - \beta} \right) \varepsilon_t - \left(\frac{\beta A(\beta)}{L - \beta} \right) \varepsilon_t - (1 - \tau) \beta A^U(\beta) \left(\frac{1 - \lambda^2}{1 - \lambda L} \right) \varepsilon_t, \quad (4.9)$$

where

$$A^U(L) = \frac{A(L)}{L - \lambda - \tau\beta(1 - \lambda^2)}. \quad (4.10)$$

¹²Notice that we have specified a process with a unit root in (4.8), while we have previously stated that we focus on stationary equilibria. The unit root in the exogenous process can be easily dealt with by specifying an AR coefficient, solve for the equilibrium and then take the limit for the coefficient going to 1. The level of the price process will not have a well defined second moment, but the dynamics can be expressed in first differences. Alternatively, one could take the first difference of the market price using equation (2.1), which would eliminate the unit root due to s_t but not the confounding dynamics, and solve directly for the first difference.

Proof. Follows directly from Theorem 1. □

The Corollary represents the information equilibrium price as being comprised of three components. The first component of the RHS of (4.9) is the perfect foresight equilibrium,

$$p_t^f = \sum_{j=0}^{\infty} \beta^j s_{t+j} = \frac{LA(L)}{L-\beta} \varepsilon_t \quad (4.11)$$

This is the IE that would emerge if agents knew current, past *and future* values of ε_t .

The second component operates a first conditioning down that takes into account the fact that future values of ε_t are not known at t . This conditioning down amounts to subtracting off a particular linear combination of future values of ε_t , specifically

$$\beta A(\beta) \sum_{j=1}^{\infty} \beta^j \varepsilon_{t+j} \quad (4.12)$$

The third component is the novel part of the representation. It represents the conditioning down related to the uninformed buyers not being able to perfectly unravel the past realizations of ε_t from the equilibrium price—the confounding dynamics. The interpretation of this term offers important insights into the working of an information equilibrium at the aggregate level. To shed light on these insights we make use of the aggregation result of Theorem 2 and so we consider informed and uninformed buyers. Let $\mathbb{E}_t^{\mathcal{I}}(s_{t+1}) = \mathbb{E}[s_{t+1} | \mathbb{V}_t(\varepsilon)]$ denote prediction formula of a fully informed buyer, and $\mathbb{E}_t^{\mathcal{U}}(s_{t+1}) = \mathbb{E}[s_{t+1} | \mathbb{V}_t(p) \vee \mathbb{M}_t(p)]$ the prediction formula of an uninformed buyer in the information equilibrium of Corollary 2. Let us assume for the moment that $\mu \equiv \tau = 0$. In the equilibrium with only uninformed buyers, agents are concerned with forecasting the discounted, infinite sum of market fundamentals, i.e., $p_t = \sum_{j=0}^{\infty} \beta^j \mathbb{E}_t^{\mathcal{U}}(s_{t+j})$. Writing out the uninformed buyers expectations of future supply using the analytic form of the equilibrium price yields

$$\mathbb{E}_t^{\mathcal{U}}(s_{t+j}) = \mathbb{E}_t^{\mathcal{I}}(s_{t+j}) - A_{j-1}^{\mathcal{U}} \left(\frac{1-\lambda^2}{1-\lambda L} \right) \varepsilon_t. \quad (4.13)$$

The uninformed agents' expectations of fundamentals at each future date are given by the expectation of fully informed agents minus a term given by the linear combination of past ε_t 's that the agents do not observe. This linear combination consists of the noise stemming from the confounding dynamics generated by $|\lambda| < 1$ (see Section 2.2, Equation (2.7)) multiplied by a coefficient that corresponds to the weight on the $(j-1)^{th}$ lag of the polynomial $A^{\mathcal{U}}(L)$ which represents the dynamics of the supply process s_t as *perceived* by the uninformed buyers in equilibrium. Uninformed agents would formulate predictions that are equal to those formulated by fully informed agents if it were not for the confounding dynamics. The information equilibrium price then contains

the accumulated noise for the expectations at all horizons, namely

$$\sum_{j=1}^{\infty} \beta^j A_{j-1}^U \left(\frac{1-\lambda^2}{1-\lambda L} \right) \varepsilon_t = \beta A^U(\beta) \left(\frac{1-\lambda^2}{1-\lambda L} \right) \varepsilon_t. \quad (4.14)$$

Notice that as $|\lambda|$ approaches 1 from below, the noise due to the confounding dynamics becomes smaller, disappearing in the limit.

When fully informed buyers are introduced into the market, so that $\mu > 0$, the noise due to confounding dynamics is affected through two channels. First, there are fewer uninformed buyers and so only a fraction $1 - \mu$ of the cumulated noise (4.14) has to be subtracted off. Second, the presence of informed buyers changes the perceived supply process $A^U(L)$ for the uninformed buyers as the equilibrium price now contains more information: both the polynomial $A^U(L)$ and λ will reflect this change. As the proportion of informed buyers increases ($\mu \rightarrow 1$), the information equilibrium approaches the full information counterpart and the third term in (4.9) vanishes.

4.4 DISPERSED CHARACTERIZATION While Theorem 2 guarantees equivalence with the informed-uninformed buyers setup at the aggregate level, there exist important differences between the two equilibria at the individual agent level. First, the dispersed information equilibrium displays a well defined cross sectional distribution of beliefs, as opposed to the degenerate distribution in the hierarchical case. Second, the cross-sectional variation is perpetual in the sense that the unconditional cross-sectional variance is positive. In other words, agents' beliefs are in perpetual disagreement. These two results are stated in terms of expectations about future prices in the following proposition.

Proposition 1. *Let $p_t = (L - \lambda)Q(L)\varepsilon_t$ be the information equilibrium characterized by Theorem 1, with $|\lambda| < 1$. The cross section of beliefs about future prices is given by*

$$\mathbb{E}_t^i(p_{t+j}) = \mathbb{E}_t^{\mathcal{I}}(p_{t+j}) - (1 - \tau)Q_{j-1} \left(\frac{1-\lambda^2}{1-\lambda L} \right) \varepsilon_t - \tau Q_{j-1} \left(\frac{1-\lambda^2}{1-\lambda L} \right) v_{it} \quad \text{for } j = 1, 2, \dots \quad (4.15)$$

The implied unconditional cross-sectional variance in beliefs is given by

$$\tau^2 (1 - \lambda^2) (Q_{j-1})^2 \sigma_v^2 \quad \text{for } j = 1, 2, \dots \quad (4.16)$$

Proof. See Appendix A. □

If one considers the interpretation of the optimal signal extraction problem under dispersed information in terms of mixed strategies, the beliefs in (4.15) have an intuitive interpretation. If information were complete, the beliefs would coincide with the expectation $\mathbb{E}_t^{\mathcal{I}}(p_{t+j})$. The difference of the beliefs of agent i with respect to the full information has two components. One is common across agents, one is specific to each agent. The

common component (the second term on the RHS of (4.15)) is the result of agent i acting *as if* uninformed with probability $1 - \tau$. Similar to the uninformed buyers in the informed-uninformed case, agent i formulates her beliefs based on the common public information embedded into prices. As a result, her beliefs will differ from the full information case according to the noise due to confounding dynamics. The idiosyncratic component (the third term on the RHS of (4.15)) is the result of the agent acting *as if* they are fully informed. In acting as fully informed, the agent will condition on their private signal ε_{it} . In so doing she will inject an idiosyncratic error into her beliefs. As for the unconditional variance of the beliefs, Proposition 1 offers an analytical form that can be very useful in calibrating key parameters of the market if data on cross-sectional beliefs on prices are available.

4.5 INFORMATION EQUILIBRIUM: AN EXAMPLE We conclude this section with a specific example which allows us to further analyze existence conditions and provide a sharper characterization of the resulting information equilibrium. Let the supply process s_t be given by

$$s_t = \rho s_{t-1} + \varepsilon_t + \theta \varepsilon_{t-1}, \quad |\rho| \leq 1. \quad (4.17)$$

The full information solution to the equilibrium price is obtained by substituting (4.17) in (3.3), which results in

$$p_t - \rho p_{t-1} = \left(\frac{1 + \theta\beta}{1 - \rho\beta} \right) \varepsilon_t + \theta \varepsilon_{t-1}. \quad (4.18)$$

Suppose that the exogenous information for the buyers is specified as in (3.4) and the parameter values are such that exactly one $|\lambda| < 1$ that satisfies (3.7) exists, then Theorem 1 provides the closed form solution for the equilibrium price as

$$p_t^* - \rho p_{t-1}^* = \left(\frac{\lambda - L}{1 - \lambda L} \right) \frac{1}{\lambda} \left[\frac{1 + \theta\beta}{1 - \rho\beta} \left(1 + \frac{(1 - \tau)\beta(1 - \lambda^2)}{\lambda - (1 - \tau(1 - \lambda^2))\beta} \right) \varepsilon_t + \lambda^2 \theta \varepsilon_{t-1} \right] \quad (4.19)$$

with λ being the solution to ¹³

$$\frac{1 + \theta\lambda}{1 - \rho\lambda} = \tau\beta \left(\frac{1 + \beta\theta}{1 - \rho\beta} \right) \frac{1 - \lambda\beta}{\lambda - (1 - \tau(1 - \lambda^2))\beta} \quad (4.20)$$

How do the two equilibria differ? Both equilibria share the autoregressive root ρ ; however, the information equilibrium p_t^* contains an additional autoregressive root at λ . This is due to the presence of confounding dynamics in equilibrium: the learning effort of the uninformed buyers results in an additional persistent effect of

¹³Condition (3.7) by construction has always a solution at $\lambda = \beta$; this particular solution can be disregarded as it is independent of the informational assumptions and non-generic.

past innovations. In addition, the process p_t^* also has an MA(2) representation, compared to the MA(1) of p_t .

To gain some insights on the different structure of the two equilibria at the aggregate level it is useful to look at the case when $\tau \rightarrow 0$. According to Corollary 1 the type of IE encountered hinges upon whether s_t spans the space of ε_t . The restriction $A(\lambda) = 0$ yields $(1 + \theta\lambda)/(1 - \rho\lambda) = 0$, which gives $\lambda = -1/\theta$. Therefore, if $|\theta| < 1$, then the s_t process spans ε_t . In this case equation (4.19) becomes

$$\tilde{p}_t - \rho\tilde{p}_{t-1} = \left(\frac{1 + \theta L}{L + \theta}\right) \left[\left(\frac{\theta + \beta}{1 - \rho\beta}\right)\varepsilon_t + \varepsilon_{t-1}\right]. \quad (4.21)$$

Figure 3 plots the impulse response functions for p_t and \tilde{p}_t for two levels of confounding dynamics: $\lambda = -1/\theta = -1/\sqrt{11}$ in the left panel, and $\lambda = -1/\theta = -1/\sqrt{2}$ in the right panel.¹⁴ The impulse responses are normalized with respect to the impulse response at impact for the price under complete information p_t . The additional parameters values are set to: $\beta = 0.985$, $\sigma_\varepsilon = 1$. We set $\rho = 1$ so that the process (4.17) can be interpreted as a diffusion process where innovations spread gradually but have a permanent effect. In response to an innovation, s_t will change permanently but such a change happens gradually over the course of two periods: at impact there is a jump to 1, after one period there is an additional jump of $1 + \theta$ and then the process levels off at the new higher value. The source of confounding dynamics lies in the second jump being bigger than the first. This is common in diffusion processes where after an initial weak diffusion phase the diffusion gradient increases and becomes maximal before decreasing and leveling off once the diffusion is completed.

The full information price p_t reacts immediately to the innovation taking into account the accumulated permanent effect of the shock on the future values of the fundamentals s_t . The scale of the reaction at impact is dictated by the discount factor β . After the initial jump the dynamics follow that of the fundamentals and so the price levels off to the new permanent level. The market price with confounding dynamics \tilde{p}_t displays substantially different behavior. First, because the agents cannot really be sure that a positive innovation has been realized, the price under-reacts at impact. The under-reaction is more pronounced for the strong confounding case (35% of the full information reaction) than for the weak one (75% of the full information reaction). At period 1, while the full information price reaches the new permanent plateau, the price with confounding dynamics overshoots the plateau by roughly 25% in both the strong and weak confounding case. For the strong confounding case, the price continues to fluctuate, but only slightly so, while the fluctuations are more persistent for the weak confounding case. The intuition for this is that the price is understood to be a bad signal in the strong confounding case, and so it gets discounted much quicker, which results in the innovation being given less relevance in the subsequent learning effort. In the weak confounding case, the price is a good signal of the innovation and so it remains important in the signal extraction problem, but in so doing the price remains affected by the learning effort for several periods in the future.

¹⁴These numbers are chosen so that the equivalent signal-to-noise ratios in a standard signal extraction problem correspond to 10 and 1, respectively.

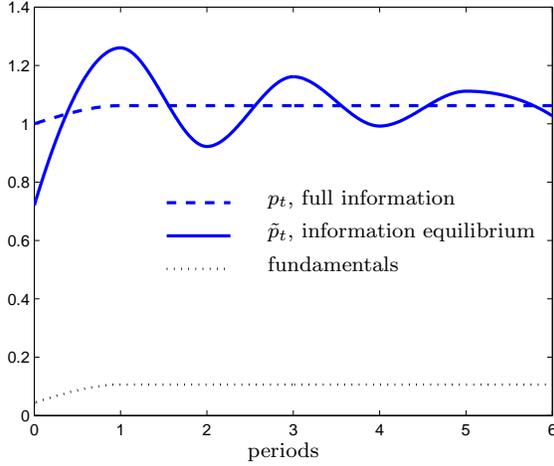


Figure 3a: strong confounding dynamics

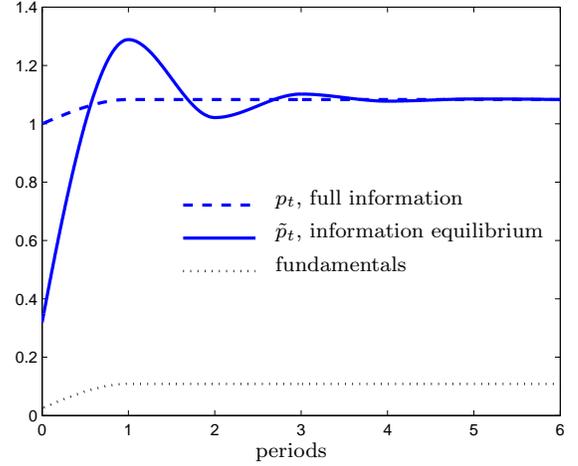


Figure 3b: weak confounding dynamics

Figure 3: Impulse response of market price to one time innovation in ε_t . The dotted line represent the response of s_t ; the dashed line is the response of the full information price p_t in Equation (4.18); the solid line is the response of the information equilibrium price \tilde{p}_t in Equation (4.21). The responses are normalized so that the full information price has a unitary reaction at period 0; other parameters values are $\rho = 1$ and $\beta = .9$.

It bears reminding that there is no exogenously superimposed noise in the market generating the equilibrium price \tilde{p}_t . The dynamics of s_t are canonical diffusion dynamics, the market price is perfectly observed and agents are fully rational. And yet the market dynamics display waves of optimism and pessimism. This example is suggestive of the potential of the equilibria belonging to the class that we characterized in Theorems 1-2 for offering a rational explanation of apparently irrational market behavior, for example, market turbulence in periods of technological innovation.

We turn next to the analysis of the existence of the information equilibrium p_t^* when $\tau > 0$ in the context of the current example. This boils down to the existence of a $|\lambda| < 1$ that satisfies (4.20). The following result summarizes how the existence condition behaves as β , ρ , θ and τ are varied. The proof is reported in Appendix A.

Result *The model described by (2.1) and (4.17) with $\beta, \rho \in (0, 1)$ and $\theta > 0$ defines a space of existence for information equilibria with confounding dynamics of the form (3.8) characterized as follows:*

(R.1) *If $\theta \leq 1$ an IE with confounding dynamics does not exist.*

(R.2) *If $\theta > 1$, an IE with confounding dynamics exists if and only if $\tau < \tau^*$ with*

$$\tau^* = \frac{(\theta - 1)(1 - \rho\beta)}{\beta(1 + \rho)(1 + \theta\beta)}$$

Figure 4 displays the existence conditions for an information equilibrium with confounding dynamics in (β, θ)

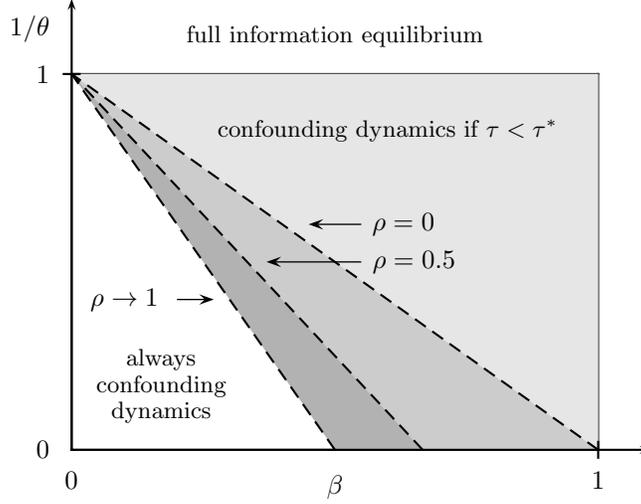


Figure 4: Existence space of Information Equilibrium with confounding dynamics as τ , ρ and θ are varied for the supply process $s_t = \rho s_{t-1} + \varepsilon_t + \theta \varepsilon_{t-1}$.

space. Four points are noteworthy. First, as is evident from the figure and condition **(R.2)**, if $\theta \leq 1$ an IE with confounding dynamics does not exist regardless of the other parameters in the model. Intuitively, if we interpret once again s_t as a diffusion process, when $\theta \leq 1$ there is no initial slow diffusion phase; the strongest diffusion takes place immediately and subsequently levels off.

Second, from condition **(R.2)**, for a certain region of the parameter space (to the right of the dashed lines in figure 4) an IE with confounding dynamics exists only if the proportion of fully informed buyers is sufficiently small. The dashed lines represent the IE that prevails as $\tau \rightarrow 1$, plotted for various values of the autoregressive parameter ρ . To the left of the dashed line, confounding dynamics will *always* be preserved in equilibrium regardless the value of τ ; from condition **(R.2)** this happens when $\theta \geq (1 + \beta)/(1 + \beta^2 - \beta\rho(1 - \beta))$. From section 2.2 we know that an increase in θ (a decrease in λ) corresponds to an increase in the noise associated with the confounding dynamics. The informational disparity between the fully informed and uninformed may become so large that no matter how many fully informed buyers participate in the market, the confounding dynamics will never be unraveled. How the discount factor β alters the space of existence is similar to that of the serial correlation parameter ρ , which is the third point to be made. As the serial correlation in the s_t process increases and β increases, it is more difficult to preserve confounding dynamics (the dashed line shifts to the left as ρ increases from 0 to 1). An increase in β and ρ leads to a longer lasting effect of current information. This results in a higher $|\lambda|$ and a decrease in the informational discrepancy between the fully informed and uninformed. Finally, the figure demonstrates the generic nature of the information equilibrium. The space of existence that preserves confounding dynamics is dense. Relatively small values of β and large values of θ *always* yield the IE given by Theorem 1 independent of τ and ρ .

5 HIGHER-ORDER BELIEFS

5.1 HIGHER-ORDER BELIEFS CHARACTERIZATION Theorem 1 shows that when $|\lambda| < 1$, agents remain dispersedly informed in equilibrium. One way to think about an equilibrium with rational agents with diverse information sets is to represent the agents behavior in terms of higher order thinking about the beliefs of others. In the context of our model, the behavior of a dispersedly informed agent i forming expectations about the next period price $\mathbb{E}(p_{t+1}|\Omega_{it})$ can be represented as agent i engaging in forming expectations about the average expectation of the equilibrium price at time $t + 1$ together with the direct expectation of the supply process at $t + 1$. Formally

$$\mathbb{E}(p_{t+1}|\Omega_{it}) = \beta \mathbb{E} \left[\int_0^1 \mathbb{E}(p_{t+2}|\Omega_{t+1}^j) dj | \Omega_{it} \right] + \mathbb{E}(s_{t+1}|\Omega_{it}).$$

To simplify notation let the average belief across agents conditional on the distribution of information sets at time t be denoted by $\bar{\mathbb{E}}_t(\cdot)$. The equilibrium price can be represented in terms of the the average beliefs of the average beliefs - second order beliefs - as follows

$$p_t = \beta^2 \bar{\mathbb{E}}_{t+1} \bar{\mathbb{E}}_t(p_{t+2}) + \beta \bar{\mathbb{E}}_t(s_{t+1}) + s_t. \quad (5.1)$$

Proceeding in this fashion one can obtain a representation of the equilibrium price in terms of the weighted sum of the average beliefs operator of higher order of future fundamentals, formally

$$p_t = s_t + \sum_{j=1}^{\infty} \beta^j \left(\prod_{i=1}^j \bar{\mathbb{E}}_{t+i-1} \right) s_{t+j} \quad (5.2)$$

The buildup in the average expectation operator in (5.2) emphasizes that the law of iterated expectations may not hold with respect to the average expectations operator. We will return to this point below. Higher order beliefs of the type in (5.1) and (5.2) are sometimes referred to as “dynamic” higher order expectations (see Townsend (1983) and Nimark (2011)).

The following proposition shows that the dynamic higher order expectations can be characterized analytically in our framework; we focus on higher order beliefs about future prices, but the same methodology delivers analytical representations of the higher order beliefs of fundamentals s_{t+j} . In what follows, let the equilibrium price of Theorem 2 be given by $p_t = (L - \lambda)Q(L)\varepsilon_t$ and we assume $|\lambda| < 1$.

Proposition 2. *In the equilibrium of Theorem 1 the dynamic average j^{th} -order beliefs of the dispersedly informed*

buyers are given by

$$\bar{\mathbb{E}}_t \bar{\mathbb{E}}_{t+1} \cdots \bar{\mathbb{E}}_{t+j-1} p_{t+j} = \bar{\mathbb{E}}_t p_{t+j} - (1-\tau) \left(\sum_{i=1}^{j-1} (\tau\lambda)^i Q_{j-i} \right) \left(\frac{1-\lambda^2}{1-\lambda L} \right) \varepsilon_t \quad (5.3)$$

Proof. See Appendix B.

To understand the result of the proposition it is useful to consider the case of second-order average beliefs $\bar{\mathbb{E}}_t \bar{\mathbb{E}}_{t+1}(p_{t+2})$ which corresponds to setting $j = 2$ in (5.3). Using the aggregation result of Theorem 2 it is possible to show that $\bar{\mathbb{E}}_t(p_{t+j}) = \tau \mathbb{E}(p_{t+j} | \Omega_t^I) + (1-\tau) \mathbb{E}(p_{t+j} | \Omega_t^U)$ where Ω_t^I (resp. Ω_t^U) denotes the information set of the informed (resp. uninformed) buyers at time t . This, in turn allows one to write the second order average beliefs as

$$\bar{\mathbb{E}}_t \bar{\mathbb{E}}_{t+1}(p_{t+2}) = \tau^2 \mathbb{E}[p_{t+2} | \Omega_t^I] + (1-\tau)^2 \mathbb{E}[p_{t+2} | \Omega_t^U] + \tau(1-\tau) \left(\mathbb{E}[\mathbb{E}(p_{t+2} | \Omega_{t+1}^U) | \Omega_t^I] + \mathbb{E}[\mathbb{E}(p_{t+2} | \Omega_{t+1}^I) | \Omega_t^U] \right) \quad (5.4)$$

Equation (5.4) shows that the second-order beliefs can be represented as a linear combination of terms that represent the beliefs of the uninformed about the beliefs of the informed, the beliefs of the informed about the beliefs of the uninformed, in addition to the direct beliefs of both. By induction it is possible to show that the third-order beliefs take a similar form and so on. The study of the dynamic average higher order beliefs under dispersed information can therefore be reduced to the study of the higher order beliefs of the informed and uninformed types of Theorem 2.

In characterizing higher-order beliefs (HOB's) of (5.4), we appeal to the intuition of Theorem 1, which argued that the equilibrium outcome is shaped along two dimensions: the fixed point in strategy and the fixed point in information. In isolating the higher order thinking of agents we will then ask two questions: (i) is higher order thinking reflected in the optimal strategy of the agent, conditional on the rational use of the equilibrium information set? (ii) does higher order thinking alter the information available in equilibrium? The existing literature on HOB's has focused exclusively on characterizing the answer to (i), interpreting the answer "yes" to that question as synonymous with forming higher order beliefs, and "no" as synonymous with the absence of higher order beliefs. While this approach works in the presence of information sets that are not determined in equilibrium, it falls short of characterizing higher-order beliefs when information is endogenous. In our setting, therefore, to fully uncover the effects of higher-order thinking one needs to answer question (i) as well as (ii). For the informed type it is easy to see that the answer to question (ii) is "no" since her information set, Ω_t^I , is by definition exogenously given and independent of any equilibrium behavior. On the other hand, for the uninformed agents the information in Ω_t^U is endogenously determined in equilibrium and, as a consequence, contains components that might be attributed solely to engaging in higher order thinking.

The following analysis focuses on second order beliefs, but the methodology applies to beliefs of higher order

as well. Both types of buyers are rational and so they will recognize that the *average* expectation of the price at $t + 1$ determines the equilibrium according to (4.2). In turn, the price at $t + 1$ will be itself a function of the average expectations of the price at $t + 2$. So if an agent could observe the average forecast of the price at $t + 2$, her prediction performance of the price at $t + 1$ would improve. Following this reasoning, the optimal expectation of both types must follow

$$\mathbb{E}[p_{t+1}|\Omega_t^{\mathcal{I}}] = \mathbb{E}[\beta\bar{\mathbb{E}}_{t+1}p_{t+2} + s_{t+1}|\Omega_t^{\mathcal{I}}], \quad \mathbb{E}[p_{t+1}|\Omega_t^{\mathcal{M}}] = \mathbb{E}[\beta\bar{\mathbb{E}}_{t+1}p_{t+2} + s_{t+1}|\Omega_t^{\mathcal{M}}] \quad (5.5)$$

It can be shown (see Appendix B) that the time $t + 1$ the expectation of the price at $t + 2$ can be written as the actual price at $t + 2$ minus the average market forecast error, namely

$$\bar{\mathbb{E}}_{t+1}p_{t+2} = p_{t+2} + \tau Q_0 \lambda \varepsilon_{t+2} + (1 - \tau) Q_0 \left(\frac{\lambda - L}{1 - \lambda L} \right) \varepsilon_{t+2}. \quad (5.6)$$

The average market forecast error on the RHS of (5.6) has two components: the first term represents the error made by the informed agents, $Q_0 \lambda \varepsilon_{t+2}$, weighted by the mass of informed agents in the market, τ ; the second term, $Q_0 \mathcal{B}_\lambda(L) \varepsilon_{t+2}$, represents the forecast error of the uninformed agents, weighted by the mass of uninformed agents in the market, $1 - \tau$.

Uninformed agents are confronted with confounding dynamics which means that their forecast error is a linear combination of current and *past* ε_t 's. Specifically, in forming their expectations for the $t + 2$ price conditional on time $t + 1$ information, the uninformed agents incur the error $Q_0 \lambda \varepsilon_{t+2} + Q_0 \left(\frac{1 - \lambda^2}{1 - \lambda L} \right) \varepsilon_{t+1}$. Informed agents can predict this error at time t by conditioning down with respect to their information set $\Omega_t^{\mathcal{I}}$. The informed second order expectation is thus

$$\mathbb{E}[\mathbb{E}(p_{t+2}|\Omega_{t+1}^{\mathcal{M}})|\Omega_t^{\mathcal{I}}] = \mathbb{E}[p_{t+2}|\Omega_t^{\mathcal{I}}] - \lambda Q_0 \left(\frac{1 - \lambda^2}{1 - \lambda L} \right) \varepsilon_t. \quad (5.7)$$

where the second term on the RHS represents the informed agents prediction at time t of the forecast error of the uninformed. This term represents the hallmark of higher-order thinking for the informed agents: the average expectation error of the price tomorrow will be correlated with the time t information set of the informed trader. The optimal strategy for the informed trader is to adjust her expectations, taking advantage of this correlated information. Notice that there is no effect of the higher order thinking on the information set of the informed, as already remarked.

Consider now the term $\mathbb{E}[\mathbb{E}(p_{t+2}|\Omega_{t+1}^{\mathcal{I}})|\Omega_t^{\mathcal{M}}]$. Uninformed agents engage in higher-order thinking by taking into account that informed agents incur in forecast errors at each future horizon and combining this with the information from the knowledge that the observed prices are generated by the equilibrium model. The uninformed agents therefore engage in forecasting the forecast errors of the informed. Because the information set of the

uninformed agents is endogenous, in equilibrium they will form a “noisy” forecast of the forecast errors of the informed. In particular, they will not be able to disentangle the forecast error of the informed from the innovations to the supply process s_t . However, they will recognize the presence of the informed agents and they will take into account how their forecast errors combine with the supply process along the equilibrium of the model. This thinking will result in the uninformed “learning” from the forecast errors of the informed since such forecast errors have a persistent effect through the equilibrium outcome.

More formally, consider the problem of the uninformed agents trying to formulate the key expectation $\mathbb{E}[\beta\mu[p_{t+2} - \mathbb{E}(p_{t+2}|\Omega_{t+1}^{\mathcal{I}})] + s_{t+1}|\Omega_t^{\mathcal{U}}]$. The fixed point condition in information from Theorem 2 requires that the argument of the expectation vanishes at $L = \lambda$ or

$$\tau\beta\lambda Q_0\varepsilon_{t+2} + A_0\varepsilon_{t+1} + A_1\varepsilon_t + A_2\varepsilon_{t-1} + \dots = (L - \lambda)G(L)\varepsilon_{t+2} \quad (5.8)$$

This equation implies that the forecast error of the informed $\mu\beta\lambda Q_0\varepsilon_{t+2}$ affects *all* the coefficients in $G(L)$, and thus all the expectations of the uninformed since

$$\mathbb{E}[\beta\mu[p_{t+2} - \mathbb{E}(p_{t+2}|\Omega_{t+1}^{\mathcal{I}})] + s_{t+1}|\Omega_t^{\mathcal{U}}] = \mathbb{E}[(L - \lambda)G(L)\varepsilon_{t+2}|\Omega_t^{\mathcal{U}}] \quad (5.9)$$

The higher order thinking of the uninformed agents results in taking into account how the forecast error of the informed affects the representation (5.8). To isolate the role of higher order thinking on the part of uninformed agents we perform the following thought exercise. We imagine that uninformed agents ignore the information coming from the forecast error of the informed by removing $\mu\beta\lambda Q_0\varepsilon_{t+2}$ from (5.8). This of course cannot be actually implemented in the equilibrium by the uninformed agents because it assumes that they are able to observe the innovations directly; however, this an exercise that as modelers we can perform. Appendix B shows that the second order expectations of the uninformed about the informed can be represented as

$$\mathbb{E}[\mathbb{E}(p_{t+2}|\Omega_{t+1}^{\mathcal{I}})|\Omega_t^{\mathcal{U}}] = \mathbb{E}(p_{t+2}|\Omega_t^{\bar{\mathcal{U}}}) + Q_0\left(\frac{1 - \lambda^2}{\lambda(1 - \lambda L)}\right)\varepsilon_t \quad (5.10)$$

where the term $\mathbb{E}_t^{\bar{\mathcal{U}}}p_{t+2}$ represents the prediction of the uninformed agents if they were to ignore the existence of informed agents in the market, i.e. ignore $\mu\beta\lambda Q_0\varepsilon_{t+2}$. The second term represents the higher order thinking of uninformed agents as they recognize the presence of informed agents and benefit from the information contained in their forecast errors.¹⁵ For the uninformed agents therefore the answer to question (ii) above is “yes”: higher order thinking is isolated by considering the interpretation of the endogenous information set as in (5.10). The

¹⁵Notice that the term $\mathbb{E}_t^{\bar{\mathcal{U}}}p_{t+2}$ is defined in order to isolate the higher thinking process of the uninformed, but, strictly speaking, is an expectation that is not measurable with respect to the information set of uninformed agents in equilibrium when $\mu > 0$. The reason is that the information set of the uninformed agents is endogenous to the particular equilibrium we are considering. This is not true for the information set of the informed agents, and therefore there is no need to distinguish the informed information set in $\mathbb{E}_t^{\mathcal{I}}p_{t+2}$ of (5.7) from the equilibrium one as they always coincide.

answer to question (i), however, is “no”: the higher order thinking of uninformed agents, once the rational interpretation of the equilibrium information set is taken into account, is not directly reflected in their optimal strategy. As a result, the equilibrium representation of the second order beliefs of the uninformed agents in (5.4) is $\mathbb{E}[\mathbb{E}(p_{t+2}|\Omega_{t+1}^I)|\Omega_t^U] = \mathbb{E}(p_{t+2}|\Omega_t^U)$. Combining this last expression with (5.7) one finally obtains an expression for the average second order dynamic expectations in the dispersed information economy

$$\bar{\mathbb{E}}_t \bar{\mathbb{E}}_{t+1}(p_{t+2}) = \bar{\mathbb{E}}_t(p_{t+2}) - \tau \lambda Q_0 \left(\frac{1 - \lambda^2}{1 - \lambda L} \right) \varepsilon_t \quad (5.11)$$

This expression together with its derivation provide the following insights into the structure of dynamic higher order expectations. The second order average dynamic expectation in the economy under dispersed information at time t is equal to the average direct expectation plus the average forecast error incurred by the dispersedly informed agents which is predictable by pooling all the information dispersed in the economy up to time t , weighted by the signal-to-noise ratio τ . Repeating the above steps for the dynamic expectations of order higher than second delivers the result of Proposition 2. The intuition for the second order average expectation extends to expectations of higher order, with weights appropriately adjusted as instructed by (5.3).

Proposition 2 also allows the analytical representation of the higher order beliefs at the individual agent level in the dispersed information economy. One can in fact show that the beliefs of agent i about the future average beliefs of the economy about future prices can be written as

$$\mathbb{E}_{it} \bar{\mathbb{E}}_{t+1}(p_{t+2}) = \mathbb{E}_{it}(p_{t+2}) - \tau \lambda Q_0 \frac{(1 - \lambda^2)}{1 - \lambda L} \varepsilon_{it}. \quad (5.12)$$

The intuition for this expression is very similar to the one offered for (5.11): the belief of agent i about the average beliefs of the economy at $t + 1$ about prices at $t + 2$ is equal to the direct beliefs of agent i plus a term that considers the predictable component of the average forecast errors that other agents will incur at $t + 1$ in predicting prices at $t + 2$. Agent i will forecast such forecast error when acting “as if” perfectly informed as instructed by the optimal signal extraction behavior. It follows that the second term on the RHS of (5.12) is a moving average of the private signal ε_{it} that takes the same form as the informed forecast of the forecast error of the uninformed in (5.11), where now the multiplication by τ can be understood as a direct consequence of the optimal signal extraction behavior. Equation (5.12) also shows that for any agent in the dispersed information economy the answers to questions (i) and (ii) above are both “yes”, since each agent inherits the behaviors of the informed and the uninformed of the aggregate representation. Hence, the higher order thinking behavior of a rational agent under dispersed information affects both the optimal strategy of the agent and the interpretation of her endogenous information set. We will use this insight into higher order beliefs to study how the removal of higher order thinking affects information diffusion in equilibrium.

5.2 HIGHER ORDER BELIEFS AND INFORMATION DIFFUSION We are now in a position to study how the formation of HOBs affects the dissemination of information in equilibrium. Our aim is to compare the information equilibrium of Theorem 1 to an equilibrium where HOBs at all horizons are forcefully removed – we call this a “No-HOBs Equilibrium.” Holding the same exogenous information assumption across the equilibria, a lower mean square forecast error will correspond to greater information diffusion. To conceptualize and then solve for the ‘No-HOBs Equilibrium’ we proceed as follows: First, using Proposition 2 we derive a representation for the information equilibrium price that isolates the noiseless HOBs of the informed agents and noisy HOBs of the uninformed. Next, we shut down these higher-order beliefs sequentially and solve for two No-HOBs equilibria—one that removes the informed agent’s HOBs and one that removes both informed and uninformed agents’ HOBs.

Using the results on higher order expectations presented above one can rewrite the equilibrium price as

$$\begin{aligned}
 p_t = & \sum_{j=1}^{\infty} (\mu\beta)^j \mathbb{E}_t^{\mathcal{I}}(s_{t+j}) + s_t \\
 & + \sum_{j=1}^{\infty} \beta^j (1-\mu)^j \mathbb{E}_t^{\mathcal{U}}(\beta\mu \mathbb{E}_{t+j}^{\mathcal{I}} p_{t+j+1} + s_{t+j}) + \mathbb{E}_t^{\mathcal{I}} \sum_{h=1}^{\infty} (\mu\beta)^h \mathbb{E}_{t+h}^{\mathcal{U}} \sum_{j=h}^{\infty} (1-\mu)^{j-h+1} \beta^{j-h+1} [\beta\mu \mathbb{E}_{t+j+1}^{\mathcal{I}} p_{t+j+2} + s_{t+j+1}] \quad (5.13)
 \end{aligned}$$

The last two terms in (5.13) capture the entire HOBs structure into the infinite future. When only fully informed buyers are present ($\mu = 1$), the expression coincides with the price under full information in (3.3). Likewise, when only uninformed buyers are present ($\mu = 0$), the expression coincides with the price under symmetric incomplete information in (4.21).

The weights assigned to the expectations in the three terms clarify the higher-order reasoning. The uninformed agents will form expectations of the sum of the s_t ’s and the entire path of future expectations of the informed agents, discounted at $\beta(1-\mu)$. The informed agents will form the “standard” discounted expectation of future s_t ’s with weight $\mu\beta$, but will also correct this forecast based upon the forecasts of the uninformed, which is the last term in (5.13). This term shows that the informed agents will correct the *entire path* of the uninformed agents’ expectations, not just the time t forecast errors.

The formation of HOBs provides uninformed agents with two additional sources of information that they would not have otherwise. The first source comes from forming noisy HOBs themselves (the penultimate term of (5.13)) and the second source comes from the informed agents forming HOBs (the last term of (5.13)). Recall that the informed agents’ HOBs correct for the serial correlation in the uninformed agents’ forecast error. In equilibrium, this information gets impounded into the price and is partially revealed to the uninformed agents. The obvious question is: How much information is revealed through the formation of HOBs?

Given that we have an analytical solution at hand, we can answer this question by forcing each agent type to not engage in higher-order thinking. The following proposition solves for two boundedly rational equilibria to isolate the two sources of information coming from the HOBs. The first equilibrium solves (5.13) but sets the last term to zero, which isolates the role of HOBs formed by the informed buyers. The second equilibrium removes

both the last term and the penultimate term in (5.13), which takes all HOBs out of the model. By taking the difference between the two equilibria, one can isolate the role of the HOBs formed by the uninformed buyers.

Proposition 3. NO-INFORMED HOBs EQUILIBRIUM. *Assume that the fully informed buyers do not form higher order beliefs (i.e., solve (5.13) removing the last term). Under the exogenous information assumption (4.1), i.e. $U_t^i = \mathbb{V}_t(\varepsilon)$ for $i \in \mu$ and $U_t^i = \{0\}$ for $i \in 1 - \mu$, a unique boundedly-rational equilibrium always exists and is determined as follows. If there exists a $|\tilde{\lambda}| < 1$ such that*

$$A(\tilde{\lambda}) - \frac{\mu\beta A(\beta)}{\tilde{\lambda} - (1 - \mu)\beta} = 0 \quad (5.14)$$

then the equilibrium price is given by

$$p_t = \frac{1}{L - \beta} \left(LA(L) - \beta A(\beta) \frac{k(L)}{k(\beta)} \right) \varepsilon_t \quad (5.15)$$

where $k(L) = \frac{\mu\tilde{\lambda}}{1 - \tilde{\lambda}\beta} - (1 - \mu) \frac{L - \tilde{\lambda}}{1 - \tilde{\lambda}L}$. If (5.16) does not hold for any $|\tilde{\lambda}| < 1$, the equilibrium is the full information equilibrium (3.3).

NO-HOBs EQUILIBRIUM. *Assume that neither the informed nor uninformed buyers form higher-order beliefs (i.e., solve (5.13) removing the last term and setting the penultimate term to $\sum_{j=1}^{\infty} \beta^j (1 - \mu)^j \mathbb{E}_t^U s_{t+j}$). Under the exogenous information assumption (4.1), i.e. $U_t^i = \mathbb{V}_t(\varepsilon)$ for $i \in \mu$ and $U_t^i = \{0\}$ for $i \in 1 - \mu$, a unique boundedly-rational equilibrium always exists and is determined as follows. If there exists a $|\lambda^*| < 1$ such that*

$$A(\lambda^*) - \frac{\mu\beta A(\beta)}{\lambda^*} = 0 \quad (5.16)$$

then the equilibrium price given by

$$p_t = \frac{1}{L - \beta} \left(LA(L) - \beta A(\beta) \kappa(L) \right) \varepsilon_t \quad (5.17)$$

where $\kappa(L) = \mu + (1 - \mu) \frac{L - \lambda^*}{1 - \lambda^*L}$. If (5.17) does not hold for any $|\lambda^*| < 1$, the equilibrium is the full information equilibrium (3.3).

Proof. See Appendix B. □

Proposition 3 allows us to state the main result of this section.

Corollary 3. *Assume $A(L) = (1 + \theta L)/(1 - \rho L)$ with $\rho \in [0, 1]$. If an IE exists with $\lambda \in (-1, 1)$, then higher-order beliefs always enhance information diffusion.*

Proof. See appendix B. □

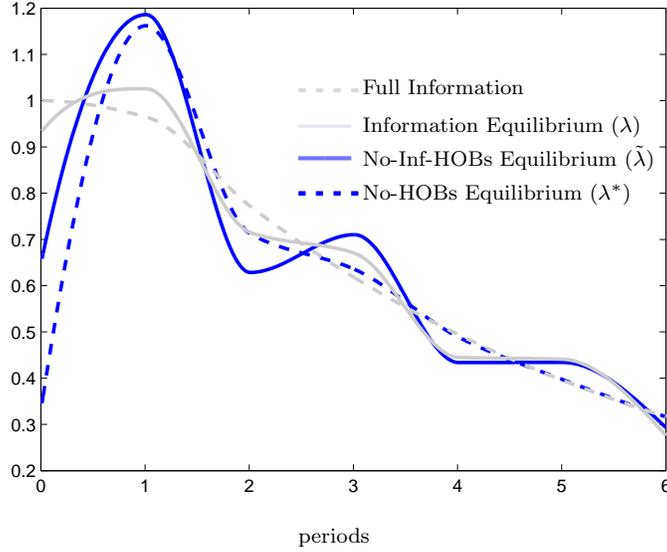


Figure 5: Impulse response of market price to one time unitary innovation in ε_t . The light dashed line is the price under full information; the solid light line is the price with all the HOBs present under confounding dynamics measured by λ ; the solid dark line is the No-Informed HOB's equilibrium price under confounding dynamics measured by $\tilde{\lambda}$; the dashed dark line is the No-Hob's equilibrium price under confounding dynamics measured by λ^* . The parameter values are $s_t = 0.8s_{t-1} + \varepsilon_t + \sqrt{11}\varepsilon_{t-1}$, $\beta = 0.985$ and $\mu = 0.06$.

The corollary essentially states that $|\lambda^*| < |\tilde{\lambda}| < |\lambda|$. Recall that as $|\lambda| \rightarrow 1$, confounding dynamics diminish and disappear altogether in the limiting case, as the discrepancy between the information set of the informed and uninformed gets smaller. We measure information diffusion as the relative difference between the informed and uninformed agents' variance of forecast error. Given that for each variant of (5.13) the price process can be written as $p_t = (L - \lambda)Q(L)\varepsilon_t$, it is straightforward to show that for each economy described in Corollary 3 and Theorem 2, the ratio of forecast errors is given by λ^2 ,

$$\frac{\mathbb{E}(p_{t+1} - \mathbb{E}_t^I p_{t+1})^2}{\mathbb{E}(p_{t+1} - \mathbb{E}_t^U p_{t+1})^2} = \lambda^2 \quad (5.18)$$

When the informed higher-order thinking is removed $|\lambda|$ declines to $|\tilde{\lambda}|$ which means that informed higher order thinking reduces the extent of the confounding dynamics and therefore has a positive effect on information diffusion in equilibrium. Intuitively, engaging in guessing the expectation of the average expectation of the average expectation and so on helps information diffusion because it forces informed agents to use their private information to guess the forecast errors of other agents. In so doing, more information is encoded into equilibrium prices and thus the variance of the forecast errors is reduced. When the uninformed higher order thinking is removed together with the informed higher order thinking, $|\lambda|$ decreases further to $|\lambda^*| < |\tilde{\lambda}|$. Even though uninformed agents form noisy HOBs, doing so increases their information and reduces their forecast errors.

To quantify the effects of higher order thinking, consider a variant of the numerical example presented in

Section (4.5). Using the process for s_t specified in (4.17), let $\rho = 0.8$, $\theta = \sqrt{11}$ and $\mu = 0.06$. The ratio of the variance of the forecast errors, (5.18), is 0.84 when all HOBs are present. This value falls to 0.49 when only uninformed agents form HOBs, (5.14), and 0.137 when neither informed nor uninformed form HOBs, (5.16). By this measure, HOBs reduce the information discrepancy between the informed and uninformed agents by a factor of seven. As a visual confirmation, figure 5 displays the impulse response of the full information equilibrium, the information equilibrium of Theorem 2 and the No-HOBs equilibria of Proposition 3 to a one time shock to the fundamentals ε_0 . The impulse responses are normalized with respect to the response at impact of the full information price. The dynamics of the equilibrium with HOBs deviates only modestly from the full information; this is due to the informational effect of a small portion of agents being fully informed. How much of the informational effect is due to the higher order thinking of fully informed agents? The impulse response for the No-HOBs equilibria reveals that higher order thinking is remarkably important for informational diffusion. Without any HOBs, the market price would under-react at impact by approximately 70% of the price with HOBs, and it would over-react a period later of around 15 – 20%. Higher order thinking is therefore essential in keeping the market price from undergoing excessive fluctuations due to slow informational diffusion.

6 CONCLUDING COMMENTS

Models with incomplete information offer a rich set of results unobtainable in representative agent, rational expectations economies and have implications for business cycle modeling, asset pricing and optimal policy, to name a few applications. The results of this paper suggest that models with dynamic dispersed information show great promise for many applications. This has been known (or at least believed) since Lucas (1972). However, solving and characterizing equilibrium has proven to be a significant challenge, impeding the progress of these models. In this paper, we derived existence and uniqueness conditions for a new class of rational expectations models, along with a solution methodology that yields analytic solutions to any dynamic model with incomplete information. The analytics, in turn, permitted insights into higher-order belief dynamics and the transmission of information in general. Given the generality of the forward-looking equation at the heart of our model, we expect the results presented in this paper to be relevant in the analysis of many dynamic economic applications.

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A PROOFS

A.1 FULL INFORMATION PRICE We want to solve for the infinite summation

$$p_t = \sum_{j=0}^{\infty} \beta^j \mathbb{E}(s_{t+j} | \mathbb{V}_t(\varepsilon)). \quad (\text{A.1})$$

In lieu of characterizing each term in the summation, we take advantage of the Riesz-Fischer Theorem and posit that the solution to (3.2) has the functional form $p_t = P(L)\varepsilon_t$.¹⁶ Using the Wiener-Kolmogorov optimal prediction formula, expectations take the form $\mathbb{E}[p_{t+1} | \mathbb{V}_t(\varepsilon)] = L^{-1}[P(L) - P_0]\varepsilon_t$. Substituting the expectation into the equilibrium equation (2.1) yields a functional equation for $P(z)$.¹⁷ As noted above, we solve for the functional fixed point problem in the space of analytic functions. The z -transform of the p_t process may be written as

$$P(z) = \frac{zA(z) - \beta P_0}{z - \beta}. \quad (\text{A.2})$$

Throughout the paper we always restrict our attention to stationary equilibria. Stationarity corresponds to the requirement that $P(z)$ has no unstable roots in the denominator. If $|\beta| \geq 1$, then (A.2) is stationary and the free parameter P_0 can be set arbitrarily. Uniqueness, then, requires $|\beta| < 1$, in which case the free parameter P_0 is set to ensure that the unstable root $|\beta| < 1$ cancels. Carrying out these steps one obtains equation (3.3) in the text.

A.2 THEOREM 1 The first step in the proof is to obtain a representation for the signal vector (ε_{it}, p_t) that can be used to formulate the expectation at the agent’s level. The representation in terms of the innovation ε_t and the noise v_{it} is

$$\begin{pmatrix} \varepsilon_{it} \\ p_t \end{pmatrix} = \begin{pmatrix} \sigma_\varepsilon & \sigma_v \\ (L - \lambda)p(L) & 0 \end{pmatrix} \begin{pmatrix} \hat{\varepsilon}_t \\ \hat{v}_{it} \end{pmatrix} = \Gamma(L) \begin{pmatrix} \hat{\varepsilon}_t \\ \hat{v}_{it} \end{pmatrix}. \quad (\text{A.3})$$

¹⁶Note that there is no need to include in our guess the possibility of a zero $|\lambda| < 1$ as it would be informationally irrelevant given the full information provided to the agents.

¹⁷In our notation we distinguish between L and z to make clear that L is an operator, while z is a complex number.

where we have re-scaled the mapping so that the innovations $\hat{\varepsilon}_t$ and the noise \hat{v}_{it} have unit variance and we have implicitly defined $p(L) = Q(L)\sigma_\varepsilon$. Let the fundamental representation be denoted by

$$\begin{pmatrix} \varepsilon_{it} \\ p_t \end{pmatrix} = \Gamma^*(L) \begin{pmatrix} w_{it}^1 \\ w_{it}^2 \end{pmatrix}. \quad (\text{A.4})$$

The lag polynomial matrix $\Gamma^*(L)$ is given by (see Rondina (2009)) $\Gamma^*(L) = \Gamma(L)W_\lambda B_\lambda(L)$ where

$$W_\lambda = \frac{1}{\sqrt{\sigma_\varepsilon^2 + \sigma_v^2}} \begin{pmatrix} \sigma_\varepsilon & -\sigma_v \\ \sigma_v & \sigma_\varepsilon \end{pmatrix} \quad \text{and} \quad B_\lambda(L) = \begin{pmatrix} 1 & 0 \\ 0 & \frac{1-\lambda L}{L-\lambda} \end{pmatrix}.$$

The vector of fundamental innovations is then given by

$$\begin{pmatrix} w_{it}^1 \\ w_{it}^2 \end{pmatrix} = B_\lambda(L^{-1})W_\lambda^T \begin{pmatrix} \hat{\varepsilon}_t \\ \hat{v}_{it} \end{pmatrix}.$$

The expectation term for agent i is provided by the second row of the Wiener-Kolmogorov prediction formula applied to the fundamental representation (A.4), which is

$$\mathbb{E}(p_{t+1} | \varepsilon_i^t, p^t) = [\Gamma_{21}^*(L) - \Gamma_{21}^*(0)] L^{-1} w_{it}^1 + [\Gamma_{22}^*(L) - \Gamma_{22}^*(0)] L^{-1} w_{it}^2. \quad (\text{A.5})$$

It is straightforward to show that

$$\begin{aligned} \Gamma_{21}^*(L) &= (L - \lambda) p(L) \frac{\sigma_\varepsilon}{\sqrt{\sigma_\varepsilon^2 + \sigma_v^2}}, & \Gamma_{21}^*(0) &= -\lambda p_0 \frac{\sigma_\varepsilon}{\sqrt{\sigma_\varepsilon^2 + \sigma_v^2}} \\ \Gamma_{22}^*(L) &= -(1 - \lambda L) p(L) \frac{\sigma_v}{\sqrt{\sigma_\varepsilon^2 + \sigma_v^2}}, & \Gamma_{22}^*(0) &= -p_0 \frac{\sigma_v}{\sqrt{\sigma_\varepsilon^2 + \sigma_v^2}}. \end{aligned}$$

Solving for the equilibrium price requires averaging across all the agents. In taking those averages, the idiosyncratic components of the innovation (the noise) will be zero and one would just have two terms that are function only of the aggregate innovation, namely

$$\int_0^1 w_{it}^1 di = w_t^1 = \frac{\sigma_\varepsilon}{\sqrt{\sigma_\varepsilon^2 + \sigma_v^2}} \hat{\varepsilon}_t \quad \text{and} \quad \int_0^1 w_{it}^2 di = w_t^2 = -\frac{\sigma_v}{\sqrt{\sigma_\varepsilon^2 + \sigma_v^2}} \frac{L - \lambda}{1 - \lambda L} \hat{\varepsilon}_t.$$

The average market expectation is then

$$\bar{\mathbb{E}}(p_{t+1}) = [(L - \lambda)p(L) + \lambda p_0] L^{-1} \frac{\sigma_\varepsilon^2}{\sigma_\varepsilon^2 + \sigma_v^2} \hat{\varepsilon}_t + [(1 - \lambda L)p(L) - p_0] L^{-1} \frac{\sigma_v^2}{\sigma_\varepsilon^2 + \sigma_v^2} \frac{L - \lambda}{1 - \lambda L} \hat{\varepsilon}_t. \quad (\text{A.6})$$

Now, if we let

$$\tau \equiv \frac{\sigma_\varepsilon^2}{\sigma_\varepsilon^2 + \sigma_v^2},$$

and we substitute the functional form of the average expectations into the equilibrium equation for p_t we would get

$$(L - \lambda)p(L) = \beta \mu L^{-1} [(L - \lambda)p(L) + \lambda p_0] + \beta(1 - \mu) L^{-1} \left[(L - \lambda)p(L) + p_0 \frac{\lambda - L}{1 - \lambda L} \right] + A(L)\sigma_\varepsilon$$

Since $p(L) = Q(L)\sigma_\varepsilon$ we can write the z -transform in ε_t space of the fixed point condition

$$(z - \lambda)Q(z) = \beta \tau z^{-1} [(z - \lambda)Q(z) + \lambda Q_0] + \beta(1 - \tau) z^{-1} \left[(z - \lambda)Q(z) + Q_0 \frac{\lambda - L}{1 - \lambda L} \right] + A(z) \quad (\text{A.7})$$

Re-arranging yields the following functional equation

$$(z - \lambda)(z - \beta)Q(z) = zA(z) + \beta Q_0 \left[\tau \lambda + (1 - \tau) \frac{\lambda - z}{1 - \lambda z} \right]$$

The $Q(\cdot)$ process will not be analytic unless the process vanishes at the poles $z = \{\lambda, \beta\}$. Evaluating at $z = \lambda$ gives the restriction on

$A(\cdot)$, $A(\lambda) = -\beta\tau Q_0$. Rearranging terms

$$\begin{aligned} (z - \beta)Q(z) &= \frac{1}{z - \lambda} \left[zA(z) + \beta Q_0 \left(\tau\lambda + (1 - \tau) \frac{\lambda - z}{1 - \lambda z} \right) \right] \\ &= \frac{1}{z - \lambda} [zA(z) + \beta Q_0 h(z)] \end{aligned} \quad (\text{A.8})$$

where $h(z) \equiv \tau\lambda + (1 - \tau) \frac{\lambda - z}{1 - \lambda z}$. Evaluating at $z = \beta$ gives $Q_0 = -\frac{A(\beta)}{h(\beta)}$ to ensure stability; this also results in uniqueness. The fixed point for λ can be then written as

$$A(\lambda) = \frac{\beta\mu A(\beta)}{h(\beta)}$$

which is (3.7). Substituting this into (A.8) delivers (3.8).

To complete the proof our definition of an Information Equilibrium requires that the information conveyed by the knowledge of the model is consistent with the information used in the expectational equation for an arbitrary agent i presented above. Such knowledge can be represented by the variable

$$m_{it} \equiv p_t - \beta \mathbb{E}(p_{t+1} | \varepsilon_i^t, p^t) = \beta \left(\bar{\mathbb{E}}(p_{t+1}) - \mathbb{E}(p_{t+1} | \varepsilon_i^t, p^t) \right) + s_t.$$

we then need to show that the fundamental representation of the signal vector $(\varepsilon_{it}, p_t, m_{it})$ is the same as the one we derived above. Essentially, we need to show that the mapping between this enlarged vector of signal and the vector of structural innovation is still of rank 1 at $L = \lambda$. Using the result in Corollary 3 to write down the explicit form of the difference between the individual expectations and the average market expectations, the mapping of interest is

$$\begin{pmatrix} \varepsilon_{it} \\ p_t \\ m_{it} \end{pmatrix} = \begin{pmatrix} \sigma_\varepsilon & \sigma_v \\ (L - \lambda)p(L) & 0 \\ A(L)\sigma_\varepsilon & \frac{\sigma_\varepsilon\sigma_v}{\sigma_\varepsilon^2 + \sigma_v^2} \left(\frac{1 - \lambda^2}{1 - \lambda z} \right) \beta p_0 \end{pmatrix} \begin{pmatrix} \hat{\varepsilon}_t \\ \hat{v}_{it} \end{pmatrix}. \quad (\text{A.9})$$

It is straightforward to show that 2 of the 3 minors of this matrix have rank 1 at $L = \lambda$. For the third minor the condition for rank 1 is

$$\frac{\sigma_\varepsilon\sigma_v}{\sigma_\varepsilon^2 + \sigma_v^2} \left(\frac{1 - \lambda^2}{1 - \lambda L} \right) \sigma_\varepsilon \beta p_0 - A(L)\sigma_\varepsilon\sigma_v = 0 \quad \text{at } L = \lambda.$$

Using the fact that $p_0 = Q_0\sigma_\varepsilon$ one can immediately see that this condition is equivalent to (3.7). Therefore, the enlarged information matrix (A.9) carries the same information as the information matrix (A.3) which means that we have characterized a fixed point in information. This completes the proof.

A.3 THEOREM 2 We conjecture that the candidate equilibrium process takes the form $p_t = (\lambda - L)Q(L)$ with $|\lambda| < 1$. It follows that the conditional expectations for the informed and uninformed types are given respectively by

$$\begin{aligned} \mathbb{E}_i^I(p_{t+1}) &= L^{-1}[(L - \lambda)Q(L) + \lambda Q_0]\varepsilon_t \\ \mathbb{E}_i^U(p_{t+1}) &= L^{-1} \left[(L - \lambda)Q(L) + Q_0 \frac{\lambda - L}{1 - \lambda L} \right] \varepsilon_t \end{aligned}$$

Substituting the two expectations into the equilibrium equation one gets

$$(L - \lambda)Q(L) = \beta\mu L^{-1}[(L - \lambda)Q(L) + \lambda Q_0] + \beta(1 - \mu)L^{-1} \left[(L - \lambda)Q(L) + Q_0 \frac{\lambda - L}{1 - \lambda L} \right] + A(L) \quad (\text{A.10})$$

which is equivalent to (A.7) once one sets $\mu = \tau$. The rest of the proof follows the proof of Theorem 1 above.

A.4 PROPOSITION 1 Once the analytic form for $\Gamma_{21}^*(L)$ and $\Gamma_{22}^*(L)$ are known one can compute $\mathbb{E}(p_{t+j}|\varepsilon_i^t, p^t)$ for any $j = 1, 2, \dots$. We show the $j = 1$ case here. Substitute $\Gamma_{21}^*(L)$ and $\Gamma_{22}^*(L)$ into (A.5) and collecting the terms that constitute (A.6), one gets

$$\begin{aligned}\mathbb{E}(p_{t+1}|\varepsilon_i^t, p^t) &= \bar{\mathbb{E}}(p_{t+1}) + \frac{\sigma_\varepsilon}{\sigma_\varepsilon^2 + \sigma_v^2} L^{-1} \left[(L - \lambda)p(L) + \lambda p_0 - (L - \lambda)p(L) + p_0 \frac{L - \lambda}{1 - \lambda L} \right] \sigma_v \hat{v}_{it} \\ &= \bar{\mathbb{E}}(p_{t+1}) + \frac{\sigma_\varepsilon}{\sigma_\varepsilon^2 + \sigma_v^2} L^{-1} \left[\lambda p_0 + p_0 \frac{L - \lambda}{1 - \lambda L} \right] \sigma_v \hat{v}_{it} \\ &= \bar{\mathbb{E}}(p_{t+1}) + \tau Q_0 \frac{1 - \lambda^2}{1 - \lambda L} v_{it},\end{aligned}\tag{A.11}$$

which completes the proof for the first statement of the theorem for $j = 1$. The variance of the term $\tau Q_0 \frac{1 - \lambda^2}{1 - \lambda L} v_{it}$ can be readily computed since the innovations v_{it} are independently distributed with variance σ_v^2 .

A.5 RESULT IN EXAMPLE The proof follows immediately from restriction (3.7) in Theorem (2). Condition **(R.1)** is derived by taking the limit of (3.7) as $\tau \rightarrow 0$. Substituting the parameters of the example, condition (3.7) with $\tau = 0$ is given by $(1 + \theta\lambda)/(1 - \rho\lambda) = 0$. Clearly, $|\lambda| < 1$ will not be a possibility when $\theta \in (0, 1)$, hence **(R.1)**. Notice that, because $\theta > 0$, then $\lambda < 0$ from (3.7). It follows that $\lambda = -1$ will be the critical value to dictate whether an equilibrium with confounding dynamics exists or not. Taking (3.7) and setting $\lambda = -1$ one obtains the expression for τ^* . For any $\tau \geq \tau^*$ one has $\lambda < -1$, while for $\tau < \tau^*$ one has $0 > \lambda > -1$ which is **(R.2)**.

B ONLINE APPENDIX (NOT FOR PUBLICATION)

B.1 ASSET DEMAND DERIVATION AND MARKET CLEARING The ubiquitous equilibrium equation (2.1) can be derived from many micro-founded models. It falls from the Lucas (1978) asset pricing model where agents are risk neutral and the shares are traded cum-dividend. Alternatively, Futia (1981) envisioned the equilibrium arising from land speculation. He assumed a fixed quantity of land and two types of traders—speculative and nonspeculative. Nonspeculative demand is assumed to arise from noise traders; that is, traders whose demand is independent of current and past prices. This demand never exceeds total supply, and therefore the difference between total supply and the nonspeculative demand is the market fundamental, s_t .

The demand for the speculative trader can be derived from a myopic investor who may choose to hold wealth in either a riskless asset which earns the return r or a risky asset. The wealth of agent i evolves according to

$$w_{i,t+1} = z_{i,t}(p_{t+1}) + (w_{i,t} - z_{i,t}p_t)(1 + r)$$

where p_t is the price of the risky asset at time t and $z_{i,t}$ is the number of units of the risky asset held at time t .

The speculative agents seeks to maximize, by choice of $z_{i,t}$, the expected value of a constant absolute risk aversion (CARA) utility function

$$-E_t^i \exp(-\gamma w_{i,t+1}), \tag{B.1}$$

where γ is the risk aversion parameter, and E_t^i denotes the time t conditional expectation of agent i . All random variables in the model are assumed to be distributed normally, so that (B.1) can be calculated from the (conditional) moment generating function for the normal random variable $-\gamma w_{i,t+1}$. That is,

$$-E_t^i \exp(-\gamma w_{i,t+1}) = -\exp\{-\gamma E_t^i(w_{i,t+1}) + (1/2)\gamma^2 v_t(w_{i,t+1})\}$$

where v_t denotes conditional variance. Note that $v_t(w_{i,t+1}) = z_{i,t}^2 v_t(p_{t+1})$. Stationarity implies the conditional variance term will be a constant; thus write $v_t(w_{i,t+1}) \equiv z_{i,t}^2 \delta$. The agent's demand function for the risky asset follows from the first-order necessary conditions for maximization and is given by

$$z_{i,t} = \frac{1}{\gamma \delta} [E_t^i p_{t+1} - \alpha p_t] \tag{B.2}$$

where $\alpha \equiv 1 + r > 1$.

Market clearing equates supply and demand, which yields

$$p_t = \alpha^{-1} \int_0^1 E_t^i p_{t+1} di - \alpha^{-1} \gamma \delta s_t \tag{B.3}$$

This relates to (2.1) by $\alpha^{-1} = \beta$ and one can think of s_t in (2.1) as being scaled by the risk aversion coefficient, γ , the opportunity cost associated with investing in the risky asset α , and the conditional variance term, δ . Clearly, δ is an endogenous object, but we abstract from this complication to make the analysis as transparent as possible.

B.2 EQUIVALENCE BETWEEN CONFOUNDING DYNAMICS AND STANDARD SIGNAL EXTRACTION It is helpful to establish a connection between the information contained in $\tilde{\varepsilon}_t$ when $|\lambda| < 1$ and a signal extraction problem cast in a more familiar setting. Suppose that agents observe an infinite history of the signal

$$z_t = \varepsilon_t + \eta_t, \tag{B.4}$$

where $\eta_t \stackrel{iid}{\sim} N(0, \sigma_\eta^2)$. The optimal prediction is well known and given by $\mathbb{E}(\varepsilon_t | z^t) = \tau z_t$, where τ is the relative weight given to the signal, $\tau = \sigma_\varepsilon^2 / (\sigma_\varepsilon^2 + \sigma_\eta^2)$. Let

$$x_t = \varepsilon_t + \theta \varepsilon_{t-1}, \quad (\text{B.5})$$

Proposition 4. *The information content of (B.5) is equivalent to (B.4), where equivalence is defined as equality of variance of the forecast error conditioned on the infinite history of the observed signal, i.e.*

$$\mathbb{E} \left[(\varepsilon_t - \mathbb{E}_{|\theta|>1}(\varepsilon_t | x^t))^2 \right] = \mathbb{E} \left[(\varepsilon_t - \mathbb{E}(\varepsilon_t | z^t))^2 \right],$$

when

$$\theta^2 = \frac{1}{\tau} \quad (\text{B.6})$$

and where $\tau = \sigma_\varepsilon^2 / (\sigma_\varepsilon^2 + \sigma_\eta^2)$.

Proof. We need to show that the representations (B.5) and (B.4) are equivalent in terms of unconditional forecast error variance

$$\mathbb{E} \left[(\varepsilon_t - \mathbb{E}(\varepsilon_t | x^t))^2 \right] = \mathbb{E} \left[(\varepsilon_t - \mathbb{E}(\varepsilon_t | z^t))^2 \right] \quad (\text{B.7})$$

when $\theta^2 = 1 + \sigma_\eta^2 / \sigma_\varepsilon^2$.

The optimal forecast $\mathbb{E}[\varepsilon_t | z^t]$ is given by weighting z_t according to the relative variance of ε , $\mathbb{E}(\varepsilon_t | z^t) = \left(\frac{\sigma_\varepsilon^2}{\sigma_\varepsilon^2 + \sigma_\eta^2} \right) z_t$ and therefore,

$$\mathbb{E} \left[(\varepsilon_t - \mathbb{E}(\varepsilon_t | z^t))^2 \right] = \frac{\sigma_\varepsilon^2 \sigma_\eta^2}{\sigma_\varepsilon^2 + \sigma_\eta^2} \quad (\text{B.8})$$

Calculating the optimal expectation for ε_t conditional on x^t requires more careful treatment. While there are many moving average representations for x_t that deliver the same observed autocorrelation structure (which is essentially all the information contained in x^t), there exists only one that minimizes the variance of the forecast error in the LHS of (B.7). We first need to take the conditional expectation $\mathbb{E}[\varepsilon_t | x^t]$. This expectation is found by deriving the fundamental moving-average representation and using the Wiener-Kolmogorov optimal prediction formula. The fundamental representation is derived through the use of Blaschke factors

$$x_t = (1 + \theta L) \left(\frac{L + \theta}{1 + \theta L} \right) \left(\frac{1 + \theta L}{L + \theta} \right) \varepsilon_t = (L + \theta) \tilde{\varepsilon}_t \quad (\text{B.9})$$

where $\tilde{\varepsilon}_t$ is defined as in (2.7). Given that (B.9) is an invertible representation then the Hilbert space spanned by current and past x_t is equivalent to the space spanned by current and past $\tilde{\varepsilon}_t$. This implies

$$\mathbb{E}(\varepsilon_t | \tilde{\varepsilon}^t) = \mathbb{E}(\varepsilon_t | x^t) \quad (\text{B.10})$$

To show (B.10) notice that (B.9) can be written as

$$\varepsilon_t = C(L) \tilde{\varepsilon}_t = \left[\frac{(\theta^{-1} + L^{-1})}{1 - (-\theta L)^{-1}} \right] \tilde{\varepsilon}_t \quad (\text{B.11})$$

Thus, while (B.9) does not have an invertible representation in current and past $\tilde{\varepsilon}$ it does have a valid expansion in current and future $\tilde{\varepsilon}$. Notice that

$$\varepsilon_t = (\theta^{-1} + L^{-1}) \sum_{j=0}^{\infty} (-\theta)^{-j} \tilde{\varepsilon}_{t+j} = (\theta^{-1} + L^{-1}) [\tilde{\varepsilon}_t + (-\theta)^{-1} \tilde{\varepsilon}_{t+1} + \dots]$$

The optimal prediction formula yields

$$\mathbb{E}(\varepsilon_t | \tilde{\varepsilon}^t) = [C(L)]_+ \tilde{\varepsilon}_t = \theta^{-1} \tilde{\varepsilon}_t = \left[\frac{1}{\theta^2 (1 + \theta^{-1} L)} \right] x_t \quad (\text{B.12})$$

We must now calculate

$$\mathbb{E} \left[(\varepsilon_t - \mathbb{E}(\varepsilon_t | x^t))^2 \right] = \mathbb{E}(\varepsilon_t^2) + \mathbb{E}(\varepsilon_t | x^t)^2 - 2\mathbb{E}(\varepsilon_t \mathbb{E}(\varepsilon_t | x^t)) \quad (\text{B.13})$$

$$= \sigma_\varepsilon^2 + \frac{1}{\theta^2} \mathbb{E}(\tilde{\varepsilon}_t^2) - \frac{2}{\theta} \mathbb{E}(\varepsilon_t \tilde{\varepsilon}_t) \quad (\text{B.14})$$

Notice that the squared modulo of the Blaschke factor is equal to 1, $(\frac{1+\theta z}{z+\theta})(\frac{1+\theta z^{-1}}{z^{-1}+\theta}) = 1$, and therefore $\mathbb{E}(\tilde{\varepsilon}^2) = \sigma_\varepsilon^2$.

To calculate $\mathbb{E}(\varepsilon_t \tilde{\varepsilon}_t)$ we use complex integration and the theory of the residue calculus,

$$\mathbb{E}(\varepsilon_t \tilde{\varepsilon}_t) = \frac{\sigma_\varepsilon^2}{2\pi i} \oint \frac{1+\theta z}{z+\theta} \frac{dz}{z} = \sigma_\varepsilon^2 \left[\lim_{z \rightarrow 0} \frac{1+\theta z}{z+\theta} \right] = \frac{\sigma_\varepsilon^2}{\theta}. \quad (\text{B.15})$$

Equations (B.14) and (B.15) give the desired result

$$\mathbb{E} \left[(\varepsilon_t - E(\varepsilon_t | x^t))^2 \right] = \left(1 - \frac{1}{\theta^2} \right) \sigma_\varepsilon^2$$

□

To substantiate the claim in the main text one needs just to recognize that by setting $\lambda = 1/\theta$ the result stated follows immediately.

B.3 PROOFS OF PROPOSITIONS FOR SECTION 5

B.3.1 PROPOSITION 2 Write the equilibrium price as $p_t = (L - \lambda)Q(L)\varepsilon_t$ where $|\lambda| < 1$ and $Q(L)$ satisfies (3.8). For $j = 1$, the time $t + 1$ average expectation of the price at $t + 2$ is given by

$$\begin{aligned} \bar{\mathbb{E}}_{t+1} p_{t+2} &= \mu \mathbb{E}_{t+1}^{\mathcal{I}} p_{t+2} + (1 - \mu) \mathbb{E}_{t+1}^{\mathcal{U}} p_{t+2} \\ &= L^{-1}(L - \lambda)Q(L)\varepsilon_{t+1} + L^{-1}Q_0[\mu\lambda - (1 - \mu)\mathcal{B}_\lambda(L)]\varepsilon_{t+1} \\ &= p_{t+2} + L^{-1}Q_0[\mu\lambda - (1 - \mu)\mathcal{B}_\lambda(L)]\varepsilon_{t+1} \end{aligned} \quad (\text{B.16})$$

The informed agent's time t expectation of the average expectation at $t + 1$ is

$$\mathbb{E}_t^{\mathcal{I}} \bar{\mathbb{E}}_{t+1} p_{t+2} = \mathbb{E}_t^{\mathcal{I}} p_{t+2} + \mu\lambda Q_0 \mathbb{E}_t^{\mathcal{I}} \varepsilon_{t+2} - Q_0(1 - \mu) \mathbb{E}_t^{\mathcal{I}} \mathcal{B}_\lambda(L) \varepsilon_{t+2}. \quad (\text{B.17})$$

Clearly $\mathbb{E}_t^{\mathcal{I}} \varepsilon_{t+2} = 0$, whereas the expectation in the last term of (B.17) is given by

$$\mathbb{E}_t^{\mathcal{I}} \mathcal{B}_\lambda(L) \varepsilon_{t+2} = L^{-2} \{ \mathcal{B}_\lambda(L) - \mathcal{B}_\lambda(0) - \mathcal{B}_\lambda(1)L \} \varepsilon_t \quad (\text{B.18})$$

where the notation $\mathcal{B}_\lambda(j)$ stands for “the sum of the coefficients of L^j ”. If we write

$$\mathcal{B}_\lambda(L) = (L - \lambda)(1 + \lambda L + \lambda^2 L^2 + \lambda^3 L^3 + \dots).$$

it is straightforward to show that $\mathcal{B}_\lambda(0) = -\lambda$ and $\mathcal{B}_\lambda(1) = (1 - \lambda)(1 + \lambda) = (1 - \lambda^2)$, from which follows

$$\mathcal{B}_\lambda(L) - \mathcal{B}_\lambda(0) - \mathcal{B}_\lambda(1)L = \frac{L - \lambda}{1 - \lambda L} + \lambda - (1 - \lambda^2)L = \frac{\lambda(1 - \lambda^2)L^2}{1 - \lambda L}.$$

Putting things together, the informed agent's expectation of the average expectation is

$$\mathbb{E}_t^{\mathcal{I}} \bar{\mathbb{E}}_{t+1} p_{t+2} = \mathbb{E}_t^{\mathcal{I}} p_{t+2} - (1 - \mu)Q_0\lambda \left(\frac{1 - \lambda^2}{1 - \lambda L} \right) \varepsilon_t \quad (\text{B.19})$$

For the uninformed,

$$\mathbb{E}_t^{\mathcal{U}} \overline{\mathbb{E}}_{t+1} p_{t+2} = \mathbb{E}_t^{\mathcal{U}} p_{t+2} + Q_0 \mu \lambda \mathbb{E}_t^{\mathcal{U}} \varepsilon_{t+2} - Q_0 (1 - \mu) \mathbb{E}_t^{\mathcal{U}} \mathcal{B}_\lambda(L) \varepsilon_{t+2}$$

As for the informed case, $\mathbb{E}_t^{\mathcal{I}} \varepsilon_{t+2} = 0$; however, the second term now is $\mathbb{E}_t^{\mathcal{U}} \mathcal{B}_\lambda(L) \varepsilon_{t+2} = 0$ because, by definition, $\mathcal{B}_\lambda(L) \varepsilon_{t+2}$ is not in the information set of the uninformed agents at time t . Hence $\mathbb{E}_t^{\mathcal{U}} \overline{\mathbb{E}}_{t+1} p_{t+2} = \mathbb{E}_t^{\mathcal{U}} p_{t+2}$: the uninformed are *not* forming higher-order expectations.

Applying the above results to the market forecast of the market forecast one gets

$$\overline{\mathbb{E}}_t \overline{\mathbb{E}}_{t+1} p_{t+2} = \mu \mathbb{E}_t^{\mathcal{I}} \overline{\mathbb{E}}_{t+1} p_{t+2} + (1 - \mu) \mathbb{E}_t^{\mathcal{U}} \overline{\mathbb{E}}_{t+1} p_{t+2} = \overline{\mathbb{E}}_t p_{t+2} - \mu(1 - \mu) Q_0 \lambda \left(\frac{1 - \lambda^2}{1 - \lambda L} \right) \varepsilon_t, \quad (\text{B.20})$$

which shows that the market forecast operator does not satisfy the law of iterated mathematical expectations. We can now characterize the entire structure of the market HOB. For $j = 2$, we need to calculate $\overline{\mathbb{E}}_t \overline{\mathbb{E}}_{t+1} \overline{\mathbb{E}}_{t+2} p_{t+3}$. From (B.33),

$$\overline{\mathbb{E}}_{t+2} p_{t+3} = p_{t+3} + Q_0 [\mu \lambda - (1 - \mu) \mathcal{B}_\lambda(L)] \varepsilon_{t+3}.$$

We then need the uninformed and informed's time $t + 1$ expectations of $\overline{\mathbb{E}}_{t+2} p_{t+3}$. For the uninformed we know from above (taking the time one period forward) that $\mathbb{E}_{t+1}^{\mathcal{U}} \overline{\mathbb{E}}_{t+2} p_{t+3} = \mathbb{E}_{t+1}^{\mathcal{U}} p_{t+3}$. From standard conditioning down one has

$$\begin{aligned} \mathbb{E}_{t+1}^{\mathcal{U}} p_{t+3} &= \left[\frac{(1 - \lambda L) Q(L)}{L^2} \right] + \mathcal{B}_\lambda(L) \varepsilon_{t+1} \\ &= L^{-2} [(L - \lambda) Q(L) - (Q_0 + (Q_1 - \lambda Q_0) L) \mathcal{B}_\lambda(L)] \varepsilon_{t+1}. \end{aligned} \quad (\text{B.21})$$

For the informed

$$\begin{aligned} \mathbb{E}_{t+1}^{\mathcal{I}} \overline{\mathbb{E}}_{t+2} p_{t+3} &= \mathbb{E}_{t+1}^{\mathcal{I}} p_{t+3} + \mu Q_0 \lambda \mathbb{E}_{t+1}^{\mathcal{I}} \varepsilon_{t+3} - (1 - \mu) Q_0 \mathbb{E}_{t+1}^{\mathcal{I}} \mathcal{B}_\lambda(L) \varepsilon_{t+3} \\ &= L^{-2} [(L - \lambda) Q(L) + \lambda Q_0 - (Q_0 - \lambda Q_1) L] \varepsilon_{t+1} - (1 - \mu) Q_0 \lambda \left(\frac{1 - \lambda^2}{1 - \lambda L} \right) \varepsilon_{t+1}. \end{aligned} \quad (\text{B.22})$$

Combining (B.21) and (B.22) gives

$$\begin{aligned} \overline{\mathbb{E}}_{t+1} \overline{\mathbb{E}}_{t+2} p_{t+3} &= p_{t+3} + \mu \{ \lambda Q_0 - (Q_0 - \lambda Q_1) L \} \varepsilon_{t+3} - \mu(1 - \mu) Q_0 \lambda \left(\frac{1 - \lambda^2}{1 - \lambda L} \right) \varepsilon_{t+1} \\ &\quad - (1 - \mu) [Q_0 + (Q_1 - \lambda Q_0) L] \mathcal{B}_\lambda(L) \varepsilon_{t+3} \end{aligned} \quad (\text{B.23})$$

Following the same argument that we used for the first order expectations it is easy to conclude that the uninformed's expectations of (B.23) are just

$$\mathbb{E}_t^{\mathcal{U}} \overline{\mathbb{E}}_{t+1} \overline{\mathbb{E}}_{t+2} p_{t+3} = \mathbb{E}_t^{\mathcal{U}} p_{t+3} \quad (\text{B.24})$$

This is because the uninformed cannot forecast the informed forecast of their forecast error; for the uninformed such forecast error belongs to information they will only receive in the future. Formally

$$\mathbb{E}_t^{\mathcal{U}} \left(\frac{1}{1 - \lambda L} \right) \varepsilon_{t+1} = \mathbb{E}_t^{\mathcal{U}} \left(\frac{1}{L - \lambda} \right) \tilde{\varepsilon}_{t+1} = \mathbb{E}_t^{\mathcal{U}} \sum_{j=0}^{\infty} \lambda^j \tilde{\varepsilon} = 0.$$

For the informed

$$\begin{aligned} \mathbb{E}_t^{\mathcal{I}} \overline{\mathbb{E}}_{t+1} \overline{\mathbb{E}}_{t+2} p_{t+3} &= \mathbb{E}_t^{\mathcal{I}} p_{t+3} - Q_0 \mu (1 - \mu) \lambda^2 \left(\frac{1 - \lambda^2}{1 - \lambda L} \right) \varepsilon_t - Q_1 (1 - \mu) \lambda \left(\frac{1 - \lambda^2}{1 - \lambda L} \right) \varepsilon_t \\ &= \mathbb{E}_t^{\mathcal{I}} p_{t+3} - (1 - \mu) (Q_0 \mu \lambda^2 + Q_1 \lambda) \left(\frac{1 - \lambda^2}{1 - \lambda L} \right) \varepsilon_t \end{aligned}$$

Therefore the average expectation is

$$\bar{\mathbb{E}}_t \bar{\mathbb{E}}_{t+1} \bar{\mathbb{E}}_{t+2} p_{t+3} = \bar{\mathbb{E}}_t p_{t+3} - (1 - \mu)(Q_0 \mu^2 \lambda^2 + Q_1 \mu \lambda) \left(\frac{1 - \lambda^2}{1 - \lambda L} \right) \varepsilon_t. \quad (\text{B.25})$$

Comparing this to (B.20) one can already see a pattern in the coefficients multiplying the noise term related to the forecast error of the uninformed. Iterating the process over and over one obtains the generic form of the higher order market expectations for prices

$$\bar{\mathbb{E}}_t \bar{\mathbb{E}}_{t+1} \cdots \bar{\mathbb{E}}_{t+j} p_{t+j+1} = \bar{\mathbb{E}}_t p_{t+j+1} - (1 - \mu) \left(\sum_{i=1}^j (\mu \lambda)^i Q_{j-i} \right) \left(\frac{1 - \lambda^2}{1 - \lambda L} \right) \varepsilon_t$$

B.3.2 DERIVATION OF EQUATION (5.12) The notation of the proof is that of Theorem 1 unless otherwise specified. We begin by noticing that

$$\mathbb{E}_{it} \bar{\mathbb{E}}_{t+1} p_{t+2} = \mu \mathbb{E}_{it} \mathbb{E}_{t+1}^{\mathcal{I}} p_{t+2} + (1 - \mu) \mathbb{E}_{it} \mathbb{E}_{t+1}^{\mathcal{U}} p_{t+2}. \quad (\text{B.26})$$

From the hierarchical equilibrium case we know that $\mathbb{E}_{t+1}^{\mathcal{U}} p_{t+2} = \mathbb{E}_{t+1}^{\mathcal{I}} p_{t+2} - Q_0 \frac{1 - \lambda^2}{1 - \lambda L} \varepsilon_{t+1}$. We also notice that, because the information set of an arbitrary agent i is strictly smaller than the information set of an informed agent of the hierarchical equilibrium and because the law of iterated expectations holds at the single agent level, we have $\mathbb{E}_{it} \mathbb{E}_{t+1} \mathbb{E}_{t+1}^{\mathcal{I}} p_{t+2} = \mathbb{E}_{it} p_{t+2}$. Because of the second property we also have that $\mathbb{E}_{it} \mathbb{E}_{t+1}^{\mathcal{U}} p_{t+2} = \mathbb{E}_{it} \mathbb{E}_{t+1} \mathbb{E}_{t+1}^{\mathcal{U}} p_{t+2}$. Therefore

$$\mathbb{E}_{it} \bar{\mathbb{E}}_{t+1} p_{t+2} = \mu \mathbb{E}_{it} p_{t+2} + (1 - \mu) \mathbb{E}_{it} p_{t+2} - (1 - \mu) Q_0 \mathbb{E}_{it} \frac{1 - \lambda^2}{1 - \lambda L} \varepsilon_{t+1}. \quad (\text{B.27})$$

The crucial step in the proof is then to show that the expectation in the last term is non-zero. In order to do so we first notice that $\frac{L - \lambda}{1 - \lambda L} \varepsilon_{t+2} = \frac{1 - \lambda^2}{1 - \lambda L} \varepsilon_{t+1} - \lambda \varepsilon_{t+2}$ and so

$$\mathbb{E} \left(\frac{1 - \lambda^2}{1 - \lambda L} \varepsilon_{t+1} | \varepsilon_i^t, p^t \right) = \mathbb{E} \left(\frac{L - \lambda}{1 - \lambda L} \varepsilon_{t+2} | \varepsilon_i^t, p^t \right). \quad (\text{B.28})$$

Then, the crucial step in the proof is to show that

$$\mathbb{E} \left(\frac{L - \lambda}{1 - \lambda L} \varepsilon_{t+2} | \varepsilon_i^t, p^t \right) = \mu \lambda \frac{(1 - \lambda^2)}{1 - \lambda L} \varepsilon_{it}. \quad (\text{B.29})$$

where $\mu \equiv \frac{\sigma_\varepsilon^2}{\sigma_\varepsilon^2 + \sigma_v^2}$. Remember that we defined

$$\tilde{\varepsilon}_t = \mathcal{B}(L) \varepsilon_t. \quad (\text{B.30})$$

To ease notation, let $\tilde{\varepsilon} = y$, then we look for $\mathbb{E}(y_{t+2} | \varepsilon_i^t, p^t) = \pi_1(L) \varepsilon_{it} + \pi_2(L) p_t$. From Theorem 1 in Rondina (2009) we know that

$$\begin{bmatrix} \pi_1(L) & \pi_2(L) \end{bmatrix} = \begin{bmatrix} L^{-2} g_{y,(\varepsilon,p)}(L) \left(\Gamma^*(L^{-1})^T \right)^{-1} \end{bmatrix}_+ \Gamma^*(L)^{-1} \quad (\text{B.31})$$

where $\Gamma^*(L)$ and (w_{it}^1, w_{it}^2) are defined in (A.4) and $g_{y,(\varepsilon,p)}(L)$ is the variance-covariance generating function between the variable to be predicted and the variables in the information set. In our case we have that

$$g_{y,(\varepsilon,p)}(L) = \begin{bmatrix} \mathcal{B}(L) \sigma_\varepsilon^2 & \mathcal{B}(L) (L^{-1} - \lambda) p (L^{-1}) \sigma_\varepsilon \end{bmatrix}.$$

Plugging in the explicit forms and solving out the algebra

$$L^{-2}g_{y,(\varepsilon,p)}(L)\left(\Gamma^*(L^{-1})^T\right)^{-1} = \frac{1}{\sqrt{\sigma_\varepsilon^2 + \sigma_v^2}} \left[L^{-2} \frac{L-\lambda}{1-\lambda L} \sigma_\varepsilon^2 + L^{-2} (L^{-1} - \lambda) p(L^{-1}) \frac{\sigma_\varepsilon^2}{\sigma_v} \quad -L^{-2} \frac{\sigma_\varepsilon^2 + \sigma_v^2}{\sigma_v} \sigma_\varepsilon \right].$$

Applying the annihilator operator to the RHS we see that the second term of the vector goes to zero. For the first term, the assumption that $p(L)$ is analytic inside the unit circle ensures that $L^{-2} (L^{-1} - \lambda) p(L^{-1})$ does not contain any term in positive power of L . We are then left with

$$\left[L^{-2} \frac{L-\lambda}{1-\lambda L} \right]_+ = \frac{\lambda(1-\lambda^2)}{1-\lambda L}, \quad (\text{B.32})$$

Summarizing we have shown that

$$\begin{bmatrix} \pi_1(L) & \pi_2(L) \end{bmatrix} = \frac{1}{\sqrt{\sigma_\varepsilon^2 + \sigma_v^2}} \begin{bmatrix} \frac{\lambda(1-\lambda^2)}{1-\lambda L} \sigma_\varepsilon^2 & 0 \end{bmatrix} \Gamma^*(L)^{-1}.$$

Notice that

$$\Gamma^*(L)^{-1} \begin{bmatrix} \varepsilon_{it} \\ p_t \end{bmatrix} = \begin{bmatrix} w_{it}^1 \\ w_{it}^2 \end{bmatrix}$$

so that

$$\mathbb{E}(y_{t+2} | \varepsilon_t^t, p^t) = \begin{bmatrix} \pi_1(L) & \pi_2(L) \end{bmatrix} \begin{bmatrix} \varepsilon_{it} \\ p_t \end{bmatrix} = \frac{1}{\sqrt{\sigma_\varepsilon^2 + \sigma_v^2}} \frac{\lambda(1-\lambda^2)}{1-\lambda L} \sigma_\varepsilon^2 w_{it}^1.$$

From the proof of Theorem 3 we know that $w_{it}^1 = \frac{1}{\sqrt{\sigma_\varepsilon^2 + \sigma_v^2}} (\varepsilon_t + v_{it})$, which, once substituted in the above expression, completes the derivation.

B.3.3 DERIVATION OF EQUATION (5.10) Write the equilibrium price as $p_t = (L - \lambda)Q(L)\varepsilon_t$ where $|\lambda| < 1$ and $Q(L)$ satisfies (3.8).

For $j = 1$, the time $t + 1$ average expectation of the price at $t + 2$ is given by

$$\begin{aligned} \bar{\mathbb{E}}_{t+1} p_{t+2} &= \mu \mathbb{E}_{t+1}^T p_{t+2} + (1 - \mu) \mathbb{E}_{t+1}^U p_{t+2} \\ &= L^{-1} (L - \lambda) Q(L) \varepsilon_{t+1} + L^{-1} Q_0 [\mu \lambda - (1 - \mu) \mathcal{B}_\lambda(L)] \varepsilon_{t+1} \\ &= p_{t+2} + L^{-1} Q_0 [\mu \lambda - (1 - \mu) \mathcal{B}_\lambda(L)] \varepsilon_{t+1} \end{aligned} \quad (\text{B.33})$$

We need to evaluate the following expectation

$$\mathbb{E}_t^U p_{t+1} = (1 - \mu) \beta \mathbb{E}_t^U p_{t+2} + \mathbb{E}_t^U [\mu \beta \mathbb{E}_{t+1}^T p_{t+2} + s_{t+1}] \quad (\text{B.34})$$

Writing out the term in brackets gives

$$\begin{aligned} \mu \beta \mathbb{E}_{t+1}^T p_{t+2} + s_{t+1} &= \mu \beta L^{-1} [(L - \lambda) Q(L) + \lambda Q_0] \varepsilon_{t+1} + A(L) \varepsilon_{t+1} \\ &= \mu \beta (L - \lambda) Q(L) \varepsilon_{t+2} + G(L) \varepsilon_{t+2} \\ &= \mu \beta p_{t+2} + G(L) \varepsilon_{t+2} \end{aligned}$$

where $G(L) \varepsilon_{t+2} = [\mu \beta \lambda Q_0 + LA(L)] \varepsilon_{t+2}$. Note that the existence condition implies that $G(L)$ must vanish at $L = \lambda$. Therefore, we may rewrite $G(L) \varepsilon_{t+2}$ as $(L - \lambda) \hat{G}(L) \varepsilon_{t+2}$, where $\hat{G}(L)$ has no zeros inside the unit circle. This implies that $G_0 = -\hat{G}_0 \lambda$, $G_i = \hat{G}_{i-1} - \lambda \hat{G}_i$, for $i = 1, \dots$ and therefore $\hat{G}_0 = -\mu \beta Q_0$, $\hat{G}_1 = (\hat{G}_0 - G_1) / \lambda = -(\mu \beta Q_0 + A_0) / \lambda$

Evaluating (B.34) yields

$$\begin{aligned}
 \mathbb{E}_t^{\mathcal{U}} p_{t+1} &= \beta \mathbb{E}_t^{\mathcal{U}} p_{t+2} + \mathbb{E}_t^{\mathcal{U}} (L - \lambda) \hat{G}(L) \varepsilon_{t+2} \\
 &= \beta \mathbb{E}_t^{\mathcal{U}} p_{t+2} + L^{-2} [(L - \lambda) \hat{G}(L) - \{\hat{G}_0 + (\hat{G}_1 - \lambda \hat{G}_0) L\} \mathcal{B}_\lambda(L)] \varepsilon_t \\
 &= \beta \mathbb{E}_t^{\mathcal{U}} p_{t+2} + s_{t+1} + \frac{A_0}{\lambda} \mathcal{B}_\lambda(L) \varepsilon_{t+1} + \left(\frac{\mu \beta Q_0 (1 - \lambda^2)}{\lambda (1 - \lambda L)} \right) \varepsilon_t
 \end{aligned} \tag{B.35}$$

Now we define $\mathbb{E}_t^{\mathcal{I}} p_{t+1}$ as (B.35) without the last term, so that

$$\mathbb{E}_t^{\mathcal{I}} p_{t+1} = \beta \mathbb{E}_t^{\mathcal{U}} p_{t+2} + s_{t+1} - \frac{A_0}{\lambda} \mathcal{B}_\lambda(L) \varepsilon_{t+1} \tag{B.36}$$

(B.36) would hold if the uninformed agents ignored the information coming from the informed agent's forecast errors. Therefore the difference between (B.35) and (B.36) must be due to HOBs. This difference is given by the last term in (B.35). Using the above definitions in conjunction with (B.34) equation (5.10) follows.

B.3.4 PROPOSITION 3, NO HOBs EQUILIBRIUM If we were to assume that informed agents acted irrationally and ignored information coming from the model, then the informed would not form HOBs and their expectations would satisfy the law of iterated expectations,

$$E_t^{\mathcal{I}}(p_{t+1}) = \beta E_t^{\mathcal{I}}(p_{t+2}) + E_t^{\mathcal{I}} s_{t+1} \tag{B.37}$$

That is, the higher-order beliefs component $(1 - \mu)(1 - \lambda^2) \left(\frac{Q_0 \lambda}{1 - \lambda L} \right) \varepsilon_t$ (which was derived in the proof of Proposition 2) is removed from the informed agents' expectation.

Assuming $|\lambda| < 1$ and $p_t = (L - \lambda)Q(L)\varepsilon_t$, then

$$E_t^{\mathcal{I}}(p_{t+1}) = \beta L^{-2} [(L - \lambda)Q(L) + \lambda Q_0 - LQ_0 + L\lambda Q_1] \varepsilon_t + L^{-1} [A(L) - A_0] \varepsilon_t$$

and equilibrium in z -transforms can be written as

$$(z - \lambda)(z - \beta)(z + \mu\beta)Q(z) = z(z + \mu\beta)A(z) - z\mu\beta A_0 + \beta G(z)Q_0 + \mu\beta^2 \lambda z Q_1 \tag{B.38}$$

where $G(z) = \mu\beta(\lambda - z) - (1 - \mu)z\mathcal{B}_\lambda(z)$. To remove the pole at $z = -\mu\beta$, Q_1 must satisfy

$$(\mu\beta)^2 A_0 + \beta G(-\mu\beta)Q_0 - \mu^2 \beta^3 \lambda Q_1 = 0$$

substituting this into (B.38) gives

$$(z - \lambda)(z - \beta)Q(z) = \left\{ zA(z) + \frac{\beta}{1 + \mu\lambda\beta} Q_0 g(z) \right\}$$

where $g(z) = \mu\lambda(1 + \lambda\beta) - (1 - \mu)z\mathcal{B}_\lambda(z)$. Removing the poles at λ and β implies the restrictions

$$A(\lambda) + \frac{\beta Q_0 \mu (1 + \lambda\beta)}{1 + \mu\lambda\beta} = 0, \quad Q_0 = \frac{-A(\beta)(1 + \mu\lambda\beta)}{g(\beta)}$$

This delivers the equilibrium conditions

$$p_t = \frac{1}{L - \beta} \left(LA(L) - \beta A(\beta) \frac{g(L)}{g(\beta)} \right) \varepsilon_t \tag{B.39}$$

and $A(\cdot)$ must satisfy

$$A(\lambda) = \frac{\beta \mu A(\beta)(1 + \lambda\beta)}{g(\beta)} \tag{B.40}$$

The equilibrium conditions (B.39) and (B.40) is the boundedly rational equilibrium assuming *first-order* higher order beliefs are removed. To remove the first- and second-order higher-order beliefs requires the informed agents' expectation to be given by

$$\begin{aligned}
 E_t^I p_{t+1} &= \beta^2 E_t^I (p_{t+3}) + E_t^I s_{t+1} + \beta E_t^I (s_{t+2}) \\
 &= \beta^2 L^{-3} [(L - \lambda)Q(L) + \lambda Q_0 - (Q_0 - \lambda Q_1)L - (Q_1 - \lambda Q_2)L^2] \varepsilon_t \\
 &\quad + L^{-1} [A(L) - A_0] \varepsilon_t + \beta L^{-2} [A(L) - A_0 - A_1 L] \varepsilon_t
 \end{aligned} \tag{B.41}$$

This assumes the law of iterated expectations applies to time $t + 1$ and $t + 2$ for the informed agents.

Substituting this expression into equilibrium yields

$$\begin{aligned}
 (z - \lambda)Q(z) &= \beta \mu \{ \beta^2 z^{-3} [(z - \lambda)Q(z) + \lambda Q_0 - (Q_0 - \lambda Q_1)z - (Q_1 - \lambda Q_2)z^2] \\
 &\quad + z^{-1} [A(z) - A_0] + \beta z^{-2} [A(z) - A_0 - A_1 z] \} \\
 &\quad + \beta (1 - \mu) z^{-1} [(z - \lambda)Q(z) - Q_0 \mathcal{B}_\lambda(z)] + A(z)
 \end{aligned}$$

Some tedious algebra delivers

$$\begin{aligned}
 (z - \lambda)(z - \beta)(z^2 + \mu\beta z + \mu\beta^2)Q(z) &= \mu\beta^3 [\lambda Q_0 - (Q_0 - \lambda Q_1)z - (Q_1 - \lambda Q_2)z^2] \\
 &\quad + \mu\beta z^2 [A(z) - A_0] + \mu\beta^2 z [A(z) - A_0 - A_1 z] \\
 &\quad - \beta(1 - \mu)z^2 [Q_0 \mathcal{B}_\lambda(z)] + z^3 A(z) \\
 &= (z^2 + \mu\beta z + \mu\beta^2)zA(z) + \beta J(z)Q_0 + \mu\beta^3 z(\lambda - z)Q_1 \\
 &\quad + \mu\beta^3 \lambda z^2 Q_2 - z(\mu\beta^2 - \mu\beta z)A_0 - \mu\beta^2 z^2 A_1
 \end{aligned}$$

where $J(z) = \mu\beta^2(\lambda - z) - z^2(1 - \mu)\mathcal{B}_\lambda(z)$.

Term hitting $Q(z)$ does not factor but it is easy to show that both zeros are inside unit circle. Write the zeros as $(z^2 + \mu\beta z + \mu\beta^2) = (z - \xi_1)(z - \xi_2)$.

$$\begin{aligned}
 (z - \lambda)(z - \beta)(z - \xi_1)(z - \xi_2)Q(z) &= (z - \xi_1)(z - \xi_2)zA(z) + \beta J(z)Q_0 + \mu\beta^3 z(\lambda - z)Q_1 \\
 &\quad + \mu\beta^3 \lambda z^2 Q_2 - z(\mu\beta^2 - \mu\beta z)A_0 - \mu\beta^2 z^2 A_1
 \end{aligned}$$

Using Q_2 and Q_1 to remove $z = \{\xi_1, \xi_2\}$ gives two restrictions and two unknowns.

$$\begin{aligned}
 \beta J(\xi_1)Q_0 + \mu\beta^3 \xi_1(\lambda - \xi_1)Q_1 + \mu\beta^3 \lambda \xi_1^2 Q_2 - \xi_1(\mu\beta^2 - \mu\beta \xi_1)A_0 - \mu\beta^2 \xi_1^2 A_1 &= 0 \\
 \beta J(\xi_2)Q_0 + \mu\beta^3 \xi_2(\lambda - \xi_2)Q_1 + \mu\beta^3 \lambda \xi_2^2 Q_2 - \xi_2(\mu\beta^2 - \mu\beta \xi_2)A_0 - \mu\beta^2 \xi_2^2 A_1 &= 0
 \end{aligned}$$

Substituting in these values, dividing by $(z - \xi_1)(z - \xi_2)$ and tedious algebra delivers

$$(z - \lambda)(z - \beta)Q(z) = zA(z) + \frac{\beta}{\kappa} Q_0 j(z) \tag{B.42}$$

where $j(z) = \mu\lambda(1 + \lambda\beta + (\lambda\beta)^2) - (1 - \mu)\mathcal{B}_\lambda(z)$, and κ is a complicated constant of $\xi_1, \xi_2, \lambda, \beta$ and μ . To remove the pole at $z = \lambda$, $A(\cdot)$ must satisfy $A(\lambda) + \frac{\beta Q_0 \mu(1 + \lambda\beta + (\lambda\beta)^2)}{\kappa} = 0$. To remove the pole at $z = \beta$, Q_0 must satisfy $Q_0 = \frac{-A(\beta)\kappa}{j(\beta)}$.

Substituting in Q_0 delivers the result

$$p_t = \frac{1}{L - \beta} \left(LA(L) - \beta A(\beta) \frac{j(L)}{j(\beta)} \right) \varepsilon_t \tag{B.43}$$

where

$$j(L) = \mu\lambda(1 + \lambda\beta + (\lambda\beta)^2) - (1 - \mu)\mathcal{B}_\lambda(L) \quad (\text{B.44})$$

and $A(\cdot)$ must satisfy

$$A(\lambda) = \frac{\beta\mu A(\beta)(1 + \lambda\beta + (\lambda\beta)^2)}{j(\beta)} \quad (\text{B.45})$$

By induction, we are converging to

$$p_t = \frac{1}{L - \beta} \left(LA(L) - \beta A(\beta) \frac{k(L)}{k(\beta)} \right) \varepsilon_t \quad (\text{B.46})$$

where

$$k(L) = \mu\lambda \left(\sum_{j=0}^n (\lambda\beta)^j \right) - (1 - \mu)\mathcal{B}_\lambda(L) \quad (\text{B.47})$$

and $A(\cdot)$ must satisfy

$$A(\lambda) = \frac{\beta\mu A(\beta) \left(\sum_{j=0}^n (\lambda\beta)^j \right)}{k(\beta)} \quad (\text{B.48})$$

Letting $n \rightarrow \infty$ delivers the desired result.

Removing Both HOBs Removing both the informed and uninformed HOBs will lead to an equilibrium in which each agent only forecasts the sum of future s_t 's. The boundedly-rational equilibrium in this setup will therefore be a convex combination of the fully informed equilibrium given by (3.3) and the fully uninformed equilibrium of Theorem 1.

B.3.5 COROLLARY 3 Given the ARMA(1,1) specification, the roots determining λ for the information equilibrium are given by the following quadratic,

$$f(\lambda) = \beta\mu\theta(1 - \rho\beta)\lambda^2 + [\beta\mu(1 + \theta\beta) - \theta(1 - \rho\beta)]\lambda - (1 + \beta\mu\theta) + \rho\beta(1 - \mu) = 0 \quad (\text{B.49})$$

If we remove the higher-order beliefs of the informed, the

$$g(\bar{\lambda}) = \theta(1 - \rho\beta)\bar{\lambda} + 1 + \beta\mu\theta - \rho\beta(1 - \mu) = 0 \quad (\text{B.50})$$

which gives

$$\bar{\lambda} = \frac{-(1 + \mu\theta\beta) + \rho\beta(1 - \mu)}{\theta(1 - \rho\beta)} \quad (\text{B.51})$$

Removing both the informed and uninformed's HOBs gives

$$h(\lambda^*) = \theta(1 - \rho\beta)\lambda^{*2} + [1 - \rho\beta + \beta\rho\mu(1 + \theta\beta)]\lambda^* - \mu\beta(1 + \theta\beta) = 0 \quad (\text{B.52})$$

The proof consists of two parts:

We will first show that $|\lambda| > |\bar{\lambda}|$ for all $\lambda \in (-1, 1)$.

From Result IE (figure 3), an IE with $|\lambda| < 1$ requires $\theta > 1$. Notice also that $\theta > 0$ implies the quadratic (B.49) is convex and $f(\lambda)|_{\lambda=0} = \rho\beta - 1 - \beta\mu(\theta + \rho) < 0$. To prove the result we show that evaluating (B.49) at the root of (B.50) delivers a negative value. Evaluating (B.49) at $\bar{\lambda}$ yields

$$\frac{\beta^2\mu[1 - \rho\beta + \mu\beta(\rho + \theta)](\rho + \theta)(\mu - 1)}{\theta(1 - \rho\beta)} < 0 \quad (\text{B.53})$$

which proves $|\lambda| > |\bar{\lambda}|$.

We now prove that $|\bar{\lambda}| > |\lambda^*|$. Removing all HOBs could yield an equilibrium with two roots inside the unit circle. The product of the two roots of (B.52) is $-\mu\beta(1 + \theta\beta)/(\theta(1 - \rho\beta))$, which is always less than (B.51) in absolute value when

$$\beta\{\mu[1 - \theta(1 - \beta)] + (1 - \mu)\rho\} < 1 \tag{B.54}$$

which holds given the restrictions on the parameter values.