

## The Market Selection Hypothesis

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A long-standing tenet in economics is that agents who do not make rational decisions are driven out of the market, see Alchian (1950), Friedman (1953) or Cootner (1967). The market selection hypothesis (MSH, hereafter) is the claim that such selection process works through the endogenous wealth redistribution that occurs when agents trade in financial markets and that the market will eventually be dominated by those agents whose beliefs are closest to the truth. Consequently, asset prices will converge to those prices that would clear the market in an economy where only those agents are present. This theory is extremely influential. It underlies the efficient-markets hypothesis and the use of rational expectations equilibrium as a solution concept in modern economics as it implies that asset prices will eventually reflect the beliefs of agents making accurate predictions. If the MSH fails, there is not much of an argument in economic theory which would justify the use of general equilibrium models with homogeneous beliefs for positive analysis.

Surprisingly, reasonably general conditions under which the MSH is true were not known until Sandroni's (ECTA, 2000) and Blume and Easley's (ECTA, 2006) contributions. These papers started a literature that grew over the last two decades. We now have a much better understanding on how the asset market structure and the traders' preferences towards intertemporal substitution, risk and ambiguity determine the long-run fate of traders with heterogeneous beliefs and, more importantly, the long-run behavior of asset prices. This talk will explain when the MSH holds, when it fails and what the open questions are.

### Readings

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