

An Examination of Heterogeneous Beliefs with a Short-Sale Constraint in a Dynamic Economy

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Abstract

We study the effects of a market-wide short-sale constraint in a dynamic economy with heterogeneous beliefs. Imposing the constraint reduces the stock price if the optimistic investors' intertemporal elasticity of substitution (IES) is less than one and increases the stock price if the optimist's IES is greater than one. In calibrated examples, the optimist's market price of risk falls and the interest rate rises when the constraint binds. Imposing the constraint leads to a higher stock volatility if the optimist's IES is less than one and a lower stock volatility if the IES is greater than one.

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