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Do markets reveal preferences or shape them?

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BACKGROUND

- This article studies whether markets reveal true preferences or consolidate shaping effects.
- Shaping and market discipline are both mechanisms by which prices generated in one trading period can affect behaviour in subsequent periods, and the effects of both can be cumulative. However, while market discipline is supposed to pull revealed preferences towards their underlying market-independent value, shaping may arbitrarily pull them towards irrelevant cues.

METHODOLOGY

- This paper presents an experiment which uses two manipulations aimed at identifying the extent of shaping effects in the absence of market discipline, and the power of market discipline to erode the effects of shaping. In the experimental setup, price cues are devoid of any relevant informational content.
- This paper uses an exogenous and non-informative manipulation to influence stated price expectations, which act as cues for valuations. This is so that a pure shaping effect can be observed, if it occurs, in the first round of trading. Then, subsequent rounds allow us to observe the effects of market discipline.
- The experiment was conducted in 18 sessions, comprised of 204 students. In each session participants took part in three auctions, each repeated eight times, for a total of 24 auction periods. In each session, there were either ten or twelve participants, who were assigned to two trading groups of either five or seven participants. One of the auctions implemented our EXP manipulation, and the remaining two auctions implemented our FBK manipulation.

KEY FINDINGS

- A fundamental issue raised by the results is that of explaining why shaping effects are *partially* but *not wholly* eroded by market discipline. There is no evidence that preferences do not exist prior to elicitation, and are *constructed* by individuals as and when they are needed.
- Experimental manipulations of exogenous and endogenous price cues can have a substantial and cumulative impact on the amount of money that people are willing to accept in exchange for items in their possession, even when values are entirely private and valuations are elicited using a demand-revealing market institution.

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- There is a systematic tendency for individuals' stated valuations in such markets to be pulled towards the prices that have been observed in previous market rounds, and/or that individuals expect to observe in current and future rounds.
- It is also found that shaping effects in isolation is significant.

POLICY ISSUES

- This paper displays evidence that challenges the traditional economic theory which states that individuals have precise true preferences that are independent of the market institution in which they are revealed.
- Substantial elements of shaping persists; to the extent that these effects enter into market prices that exert continuing influences on stated valuations, the operation of markets may actually consolidate them.

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