Inelastic Demand at the Extensive and Intensive Margins

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Abstract

We decompose investor demand into its extensive margin—initiating or liquidating a position—and intensive margin—scaling an existing position. Extensive demand is economically large, accounting for 40% of institutional and 80% of retail flows, and its estimated price elasticity is closer to zero and often positive. Extensive demand is primarily driven by past returns and attention, whereas intensive demand reflects fundamentals. To account for these findings, we develop a Grossman–Stiglitz-style model of inelastic markets in which extensive flows act as unobservable endogenous demand shocks and investors learn from prices based on their subjective expectations about these flows. Learning from prices leads to a more inelastic, and even upward-sloping, extensive demand curve. Embedding the model in an asset demand system, we structurally estimate both elasticities under alternative specifications of flow expectations and find that extrapolative expectations best fit the data. Reduced-form evidence and counterfactual analysis both show that as the share of extensive demand rises, prices, volatility, and firm-specific price informativeness increase, while market-wide informativeness declines.

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