Information-Constrained Optima with Retrading: An Externality and Its Market-Based Solution

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Abstract

This paper studies the efficiency of competitive equilibria in environments with a moral hazard problem and unobserved states, both with re trading in ex post spot markets. The interaction between private information problems and the possibility of retrade creates an externality, unless preferences have special, restrictive properties. The externality is internalized by allowing agents to contract ex ante on market fundamentals determining the spot price or interest rate, over and above contracting on actions and outputs. Then competitive equilibria are equivalent with the appropriate notion of constrained Pareto optimality. Examples show that it is possible to have multiple market fundamentals or price-islands, created endogenously in equilibrium.