A Market-Based Solution for Fire Sales and Other Pecuniary Externalities*

Weerachart T. Kilenthong[†]and Robert M. Townsend[‡]

Abstract

Pecuniary externalities are removed with market exchanges that internalize agent types' influence on future prices. Agents choose in the initial period from among various possible prices they want to prevail in the future and buy or sell rights in these market exchanges for future trade. One can think of contemporary exchanges or trading houses, earmarked by these specified future prices. Each agent can choose the exchange it wants without regard to what any other agent is doing. But crucially, the right to trade in each and every exchange is priced. The fee structure has a per unit price and quantity decomposition: a price, as determined by the exchange chosen, times the quantity of type-specific future excess demand, as determined by its chosen future pre-trade position, namely, savings and security holdings, and the chosen future price.

*We would like to thank Anmol Bhandari, Daniel Ehrlich, Masao Fukui, Mikhail Golosov, Lars Hansen, Bengt Holmstrom, Edward S. Prescott, Thomas Sargent, Alp Simsek, Harald Uhlig, Randall Wright, Haoxiang Zhu, the editor and anonymous referees, and seminar participants at conferences. Sartja Duangchaiyoosook provided excellent research assistance. Tee Kilenthong is grateful to financial support from UTCC. Robert Townsend is grateful to financial support from the NICHD under grant R01 HD027638, the CEPR and the DFID under grant MRG002_1255, the John Templeton Foundation, and the CFSP at the University of Chicago through a grant from the Bill & Melinda Gates Foundation. The findings and conclusions contained in the report are those of the author(s) and do not necessarily represent the views of the funders.

[†]University of the Thai Chamber of Commerce.

[‡]Massachusetts Institute of Technology.