A Market Based Solution to Price Externalities: A Generalized Framework*

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Abstract

Pecuniary externalities have regained the interest of researchers as they seek policy interventions and regulations to remedy externality-induced distortions, e.g., balance sheet effects, amplifiers and fire sales. We show how bundling, exclusivity and additional markets internalize these pecuniary externalities; ex ante competition can achieve a constrained-efficient allocation. We cover a large variety of example economies which differ from one another in the particular source of the constraint generating the externality. We do not need to identify and quantify some policy intervention. With the appropriate ex ante design we can let markets solve the problem.

Keywords: price externalities; segregated exchanges; Walrasian equilibrium; market-based solution; collateral; exogenous incomplete markets; moral hazard with retrading; hidden information with retrading; liquidity constraints; fire sales.

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