

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

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Abstract

We show how bundling, exclusivity and additional markets internalize fire sales and other pecuniary externalities. Ex ante competition can achieve a constrained efficient allocation. The solution can be put rather simply: create segregated market exchanges which specify prices in advance and price the right to trade in these markets so that participant types pay, or are compensated, consistent with the market exchange they choose and that type's excess demand contribution to the price in that exchange. 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; markets for rights to trade; market-based solution; collateral; exogenous incomplete markets; fire sales.

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