

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

Weerachart T. Kilenthong

University of the Thai Chamber of Commerce

Robert M. Townsend

Massachusetts Institute of Technology

August 7, 2014

## 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.

---

\*Tee Kilenthong is grateful to financial support from the University of the Thai Chamber of Commerce (UTCC). Robert Townsend is grateful to financial support from the Eunice Kennedy Shriver National Institute of Child Health and Human Development (NICHD) under grant R01 HD027638, the Centre for Economic Policy Research (CEPR) and the Department for International Development (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.