

Segregated Security Exchanges with Ex Ante Rights to Trade

A Market-Based Solution to Collateral-Constrained Externalities*

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Abstract

This paper studies a competitive general equilibrium model with default and endogenous collateralized contracts. The possibility of trade in spot markets creates externalities, as spot prices and the bindingness of collateral constraints interact. We propose a market based solution which overcomes the externalities problem and obviates the needs for any government policy intervention. If agents are allowed to contract ex ante on market fundamentals determining the state-contingent spot prices used to unwind collateral, over and above contracting on true underlying states of the world, then standard existence and welfare theorems apply, that is, competitive equilibria are equivalent with Pareto optima.

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