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Pareto improving financial innovation in incomplete markets



| Research Articles | Published: April 1998

| Volume 11, pages 467–494, (1998) [Cite this article](#)[Economic Theory](#)[Aims and scope](#) →[Submit manuscript](#) →[David Cass](#)¹ & [Alessandro Citanna](#)² **246** Accesses  **75** Citations  **3** Altmetric [Explore all metrics](#) →

Summary.

In this paper we develop a differential technique for investigating the welfare effects of financial innovation in incomplete markets. Utilizing this technique, and after parametrizing the standard competitive, pure-exchange economy by both endowments and utility functions, we establish the following (weakly) generic property: Let S be the number of states, I be the number of assets and H be the number of households, and consider a particular financial equilibrium. Then, provided that the degree of market incompleteness is sufficiently larger than the extent of household heterogeneity, $S - I \geq 2H - 1$ [resp. $S - I \geq H + 1$], there is an open set of single assets [resp. pairs of assets] whose introduction can make every household better off (and, symmetrically, an open set of single assets [resp. pairs of assets] whose introduction can make them all worse off). We also devise a very simple nonparametric procedure for reducing extensive household heterogeneity

to manageable size, a procedure which not only makes our restrictions on market incompleteness more palatable, but could also prove to be quite useful in other applications involving smooth analysis.

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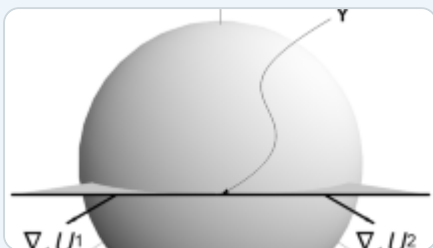
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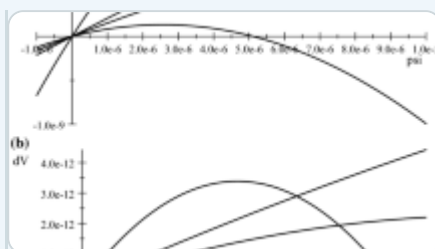
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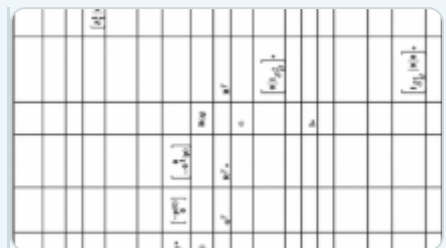
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Received: August 14, 1995; revised version: April 14, 1997

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About this article

Cite this article

Cass, D., Citanna, A. Pareto improving financial innovation in incomplete markets. *Economic Theory* **11**, 467–494 (1998). <https://doi.org/10.1007/s001990050198>

Issue Date

April 1998

DOI

<https://doi.org/10.1007/s001990050198>

[JEL Classification Numbers: C60](#)

[D60](#)

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