Pareto improving financial innovation in incomplete markets

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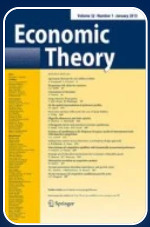

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Summary.

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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