When Borch's Theorem does not apply: Some key implications of market incompleteness, with policy relevance today

Prof. Jacques Drèze, Université catholique de Louvain

Abstract

Markets are incomplete when the assets available to the agents do not span the space of future contingencies. Efficiency is then assessed by the weak criterion of "constrained efficiency" (efficiency relative to the set of allocations compatible with the asset structure). That criterion requires firms to optimise relative to shadow-prices reflecting shareholder preferences. Yet, even when they do so, competitive quilibria on the markets for assets and commodities fail (generically) to be constrained efficient. Pareto-superior allocations can be implemented through price/wage rigidities and quantity constraints. But nominal rigidities are conducive to multiple equilibria, implying endogenous macroeconomic uncertainties that compound the primitive (exogenous) uncertainties. Various policy implications can be drawn, which are of some relevance to the current crisis.