Abstract:
Heterogeneous beliefs among market participants can lead to questionable speculative trading that goes beyond any risk-sharing motives. We demonstrate that such unwarranted betting behavior in market equilibrium can be mitigated by introducing nonlinear pricing for ambiguous contracts, without compromising legitimate risk-hedging activities. While Arrow-Debreu equilibria generally fail to achieve belief-neutral efficiency, we establish a modified version of the first welfare theorem in which equilibria with nonlinear prices uphold belief-neutral efficiency. Moreover, we show that belief-neutral efficiency, as a regulatory criterion, can be ensured by introducing transaction costs.