Dynamic Thin Markets

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Abstract. Extensive empirical research has shown that in many markets institutional investors have a significant impact on prices and mitigate its adverse effects through their trading strategies. This paper develops a dynamic model of such thin markets, in which the market structure is one of bilateral oligopoly. The paper demonstrates that market thinness qualitatively changes equilibrium properties of prices and dynamic trading strategies, compared to the existing theories of asset pricing. The predictions match a number of empirical facts that are hard to reconcile with the competitive or Cournot-based models. The paper further establishes that the nonstrategic general-equilibrium approach and the strategic approach to trade via Nash in demands are dual representations of a model with endogenous price impact. The proposed approach yields an analytical framework that can be used to study dynamic markets with bilateral market power.

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