

WCAS Center for Economic Theory
Kellogg Center for Mathematical Studies in
Economics and Management Science
Bag Lunch Theory Seminar

Thursday, April 2

12:15-1:15pm

Jacobs G43

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Endogenous Intermediation in OTC Markets (with Ana Babus)

ABSTRACT: We provide a theory of trading through intermediaries in over-the-counter markets. In our model, the role of intermediaries is to sustain unsecured trade. When agents borrow funds without pledging collateral, they can invest an amount in risky projects and increase total surplus. We propose a set-up in which traders in the OTC market are connected through a network. Agents are informed about the actions of their neighbors, and, at the same time, can trade with their counterparty through a path of intermediaries in the network. Intermediaries that facilitate unsecured trade receive, in exchange, a fee. In addition, links are costly. Both borrowers and intermediaries can default on their obligations when trade is unsecured. We show that trading through a network is essential to support investment levels that generate positive gains from unsecured trade, when agents are unlikely to meet the same counterparty again in the market. While unsecured trade can be sustained in various classes of network, the central agent in a star network can receive a higher share of the surplus as he accrues higher fees. Nevertheless, we show that the star network is the constrained efficient configuration.

<http://www.kellogg.northwestern.edu/research/math/centerinfo/baglunch.htm>