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A Case for Incomplete Markets*

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Abstract
If two rational agents want to trade and there are no externalities, then trade is Pareto improving. Economists generally oppose restrictions on such trade. Complete markets allocations are Pareto optimal and thus complete markets are generally viewed as good. But when individuals want to trade because of heterogenous beliefs, this standard argument is less compelling. We illustrate this in a standard general equilibrium setting and explore potential social benefits from restrictions on trade that make markets incomplete.

Keywords: social welfare, heterogeneous beliefs, spurious unanimity, speculation, incomplete markets, financial regulation

1 Introduction

A conventional wisdom in the economics profession is that complete markets are good. The welfare theorems state that complete markets outcomes are

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