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Risk Externalities: When financial imperfections are not the problem, but part of the solution *

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Abstract

We model an economy with complete financial markets where one agent's actions impose an externality on other agents by altering the probability distribution of their risks, and show that limiting the ability of that agent to diversify his risks creates incentives for him to internalize the welfare effects of his decisions, leading to a welfare improvement. Hence, in the presence of risk externalities, disturbing the functioning of perfect financial markets can be socially beneficial. An important implication is, for instance, that allowing oil companies to diversify their exploration risks may result in an inefficiently high risk of environmental catastrophes.

JEL classification: D52; D53; D62; Q50
Keywords: externalities; financial markets; constrained inefficiency

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