“Consistent Conjectural Equilibrium”

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Abstract

This paper proposes a framework to study market interactions in an economy, in which a trade of some of the goods is restricted to a small group of households. It departs from the classic assumption of price taking behavior in this group, and replaces it with the assumption that households have a market power and exploit it to maximize their preferences. It proposes a concept of equilibrium and provides existence results in a smooth separable economy. It also demonstrates generic Pareto inefficiency of equilibrium allocation. In the second part of the paper, it is argued by means of a canonical example that the exploitation of a market power may lead to insufficient insurance. Finally, it is shown that for large economies, market power disappears and market interactions lead to a nearly competitive outcome. The rate of convergence to a competitive outcome is related with a degree of a risk aversion of households.