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Search, Dealers, and the Terms of Trade[1]

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I study a search-theoretic model with pairwise meetings where dealers arise endogenously. The extent of intermediation depends on its cost, trade frictions, and the dealers' ability to negotiate favorable terms of trade. Under Nash bargaining, there is a unique equilibrium where dealers buy and hold the low-storage-cost good and, depending on their relative bargaining power, resell it at a premium or a discount. The distribution of the terms of trade is nondegenerate unless storage cost and frictions vanish. Due to an externality created by intermediation, the efficient allocation can be achieved only if dealers can charge a positive markup.
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1. INTRODUCTION

I construct a search-theoretic environment that allows endogenous determination of the number of trade facilitators and the negotiated terms of trade. In it, mediated exchange emerges as a natural response to market frictions. I study how the incidence of intermediation responds to economic incentives linked to frictions, intermediation costs, the availability of different goods, and the ability to negotiate favorable terms of trade.[2] I also complement work on matching models of exchange by pointing to the implications of the absence or the type of pricing mechanism for existence

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[2] A number of studies have focused on intermediation in bilateral search markets with fixed prices. Examples include Rubinstein and Wolinsky (1987), Yavas (1994), Li (1998), and Shevchenko (1999).

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and efficiency of equilibria. I do so by proving existence of equilibria for a simple transaction pattern, for which I characterize the terms of trade and the extent of intermediation and study the efficiency properties.

The economy is modeled in Section 2, along the lines of Kiyotaki and Wright (1989). This is a natural starting point because the model's frictions make the role of intermediation explicit: certain agents choose to undertake the role of dealers, costly storing a commodity they do not consume to resell it to others. I relax the assumption of fixed terms of trade (as in Shi, 1995, and Trejos and Wright, 1995), but also of exogenous distribution of agents specialized in each consumption−production activity (as in Wright, 1995). I study the fundamental transaction pattern, where some agents engage in a sequence of indirect trades involving only the lowest-storage-cost good. Several transaction patterns have been shown to exist in this class of models (e.g., Kehoe *et al.*, 1993). I focus on the fundamental pattern for several reasons. To study the link between absence (or choice) of price mechanisms and existence of equilibria, I restrict attention to a single trade pattern; investigating more than one provides little additional insight. Focusing on fundamental equilibria allows me to provide an especially clear illustration of the subject of interest by resolving an issue raised by Wright (1995). He proves the nonexistence of fundamental equilibria when agents choose their specialty production, and the terms of trade are fixed at par. In fact, I prove existence of a continuum of "prices" consistent with a fundamental strategy. Finally, the fundamental strategy is often considered the most "natural" when trade requires costly storage of goods. This has been suggested by studies of similar synthetic and experimental economies (Marimon *et al.*, 1990; Brown, 1996; Duffy and Ochs, 1999).[3]

I develop the analysis in Section 3, assuming that the negotiated terms of trade satisfy a Nash bargaining protocol. In Section 4, I prove that equilibria exist where dealers arise endogenously only if their bargaining position is not extreme. When dealers are weak bargainers, they may sell at a discount but charge a markup on their sales when they are strong negotiators. Impatient consumers are willing to pay a premium, and producers offer discounts, to someone capable of quickly satisfying their effective demand. This obtains even if search frictions vanish. I find that in equilibrium there is terms of trade dispersion, which, however, may disappear as frictions and intermediation costs vanish (as in Camera and Corbae, 1999). The extent of intermediation responds in an intuitive way to changes in fundamentals. For example, as storage costs fall, more

[3] In particular, Duffy and Ochs emphasize how subjects show a strong tendency to play fundamental strategies (over others) irrespective of marketability conditions in the experimental economy.

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