The benefits of market thickness for niche products

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Abstract

We use an independent private values model to analyze the social benefits and costs of monopoly market makers. Calling products niche (mass) if the fraction of agents who trade in a Walrasian market is small (large), we show that for sufficiently niche products a thick market monopoly generates more consumer (producer) surplus per buyer (seller) than ex post efficient bilateral trade. Moreover, relative to bilateral trade, the sorting benefits of thick markets grow unboundedly for increasingly niche products. If bilateral trade offers an outside option to trading with a thick market monopoly, mass products better mitigate the monopoly’s market power.

Keywords: bilateral trade, Walrasian markets, thick market monopoly, competing exchanges
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1 Introduction

The emergence of online technology giants has fueled public policy debates concerning the appropriate regulation of large monopoly firms. Digital storefronts have enabled online platforms to operate at a scale that is orders of magnitude larger than traditional brick-and-mortar firms. Analyzing the social costs and benefits of these large platforms requires an understanding of the economic forces that govern their size and market power.

In this paper we introduce a simple independent private values model that provides a microfoundation for the social costs and benefits of monopoly market makers, where we distinguish between both the thickness of markets and the nature of products. Thin markets are modelled in terms of a bilateral trade problem, while thick markets involve a continuum of buyers and sellers whose values and costs have the same distributions as those from the bilateral trade problem. The extent to which a product is niche is captured by truncating the distributions from which buyers and sellers draw their types. As products become increasingly niche the probability that agents can feasibly trade in the bilateral trade problem and the quantity traded in a thick Walrasian market decrease. This model gives rise to increasing returns to scale in market making because there is a double coincidence of wants problem in the bilateral trade setting that is alleviated in the thick market setting. We show that for sufficiently niche products, a profit-maximizing monopoly operating a thick market generates more consumer surplus per buyer and producer surplus per seller than ex post efficient bilateral trade. Indeed, in the limit as products become perfectly niche, the ratios of both per buyer consumer surplus and per seller producer surplus under the thick market monopoly to first-best social surplus under bilateral trade diverge to infinity.

We also establish two related invariance results. We show that the severity of the incentive problem in bilateral trade, which is captured by the ratio of second-best social surplus divided by first-best social surplus, is independent of the nature of the product. Likewise, we show that, relative to an efficient thick market, the harm from a thick market monopoly does not vary with how niche or mass a product is. The latter implies that the rationale for or against government intervention in a thick monopoly market does not depend on the nature of the product. Moreover, it shows that when products are sufficiently niche the benefits of thick market monopolies relative to thin markets for consumer and producer surplus are first order, while their harm relative to efficient thick markets is second order.

That said, there is a sense in which thick market monopolies may be more harmful for niche products than for mass products, relative to efficient thick markets. Assuming that

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1 For example, in the early 2000s the number of book titles available on Amazon was twenty times that of a typical, traditional book store (see Brynjolfsson et al., 2003; Waldfogel, 2017).
competing bilateral exchanges offer agents an outside option to trading with the thick market monopoly, we show in an extension that these competing exchanges are more effective at curbing the market power of a thick market monopoly the less niche a product is. The intuition is simply that the double coincidence of wants problem becomes more severe of an obstacle, and therefore the bilateral exchange a less effective competitor, the more niche a product is.

Oliver Williamson made the important observation that larger firms outperform smaller ones because they can always replicate what the smaller ones do, and sometimes do better by *intervening selectively* (Williamson 1985). Of course, the same logic applies to markets because thicker markets can always execute the same trades as smaller, standalone markets and can sometimes execute additional or more valuable trades. This gives rise to increasing returns to scale even when the market maker’s technology exhibits constant marginal costs per trade.

Despite its relevance, the ability of thick markets to overcome the double coincidence of wants problem has received relatively scant attention in the mechanism design and the related double-auctions literature. The latter focuses on incentives and has established that the incentive cost of thin markets vanishes quickly as market size increases; see, for example, Gresik and Satterthwaite (1989), Satterthwaite and Williams (1989), McAfee (1992), Rustichini et al. (1994), Satterthwaite and Williams (2002), Tatur (2005), Cripps and Swinkels (2006), Kojima and Yamashita (2017), and Loertscher and Mezzetti (2021). This shows that, as far as incentives are concerned, the benefits from increasing market thickness are small to none. Without necessarily being framed in this way, this literature provides one possible justification for the aggressive approach taken by antitrust authorities of numerous countries to technology giants such as Amazon, Apple, Google, Microsoft and Facebook, whose size and behaviour are perceived as anticompetitive and as an abuse of market power. Our paper contributes to these ongoing debates by distilling what may be an issue of first-order importance: the benefits of market thickness and the increasing returns to scale in market making that arise for niche products. According to Waldfogel (2017), digitalization has led to a “golden age of music, movies, books and television.” Anderson (2006) provides an early account of the benefits that accrue to consumers (and producers) from the access to the “long tail” that digitalization grants, noting that “Netflix changed the economics of niches, and in so doing, reshaped our understanding about what people actually want to watch” and reporting that for books, “Barnes & Noble found that the bottom 1.2 million titles represent

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2One notable exception is Bulow and Klemperer (1996) who demonstrate the importance of increasing the number of buyers in one-sided settings by showing that a second-price auction with no reserve price but one additional bidder outperforms the optimal auction.
just 1.7 percent of its instore sales, but a full 10 percent of its online (bn.com) sales.³

Some of the key issues this paper brings to light are also present in Loertscher et al. (2021), but are somewhat camouflaged there by the dynamic setting. By studying a one-shot setup, the present paper provides a clean-cut and transparent analysis of the benefits of thicker markets, and the relative importance of incentives and improved matching in thicker markets. Our extension in which bilateral trade offers an outside option to trading with a monopoly draws inspiration from the literature on intermediaries facing a competing exchange; see Gehrig (1993), Spulber (2002), Rust and Hall (2003), and Loertscher and Niedermaier (2020). An important departure of our model from the approach in this literature is that we assume that the competing exchanges involve bilateral trade, which implies that the value of the outside option for agents depends on whether products are niche or mass. In contrast, in the aforementioned papers, the competing exchanges are thick markets.

The remainder of this paper is organized as follows. Section 2 introduces the setup. In Section 3 we derive our results concerning thick Walrasian markets and thick market monopolies and relate them to properties of the bilateral trade problem. Section 4 discusses returns to scale in market making for niche products, as well as the implications of competing bilateral exchanges for market power in markets for niche products. Section 5 concludes the paper.

2 Setup

Throughout this paper we consider static market settings involving risk-neutral buyers and sellers with unit demand and unit capacity, respectively, whose utility functions are quasi-linear. We assume that each buyer is privately informed about the realization of its value \( v \) and each seller is privately informed about its realized cost \( c \). With the exception of the analysis in Section 4.2 the value of the outside option of not participating in the market is 0 for every agent.

We first introduce the notion of a mass product. In markets for a mass product buyers and sellers draw their types from distributions with a common support. Specifically, buyer values \( v \in [0, 1] \) are distributed according to the distribution \( F \) with density \( f \) that has full support on \([0, 1]\). Similarly, seller costs \( c \in [0, 1] \) are distributed according to the distribution \( G \) with density \( g \) that has full support on \([0, 1]\). For any \( \alpha \in [0, 1] \), the weighted virtual type

³Brynjolfsson et al. (2003) estimate that Amazon’s book sales for titles ranked outside the top 100,000 accounted for 39.2% of total book sales of Amazon.
functions are then

\[ \Phi_\alpha(v) := v - \alpha \frac{1 - F(v)}{f(v)} \]  
and  
\[ \Gamma_\alpha(c) := c + \alpha \frac{G(c)}{g(c)}. \]

As is well known, virtual value functions can be interpreted as marginal revenue functions while virtual cost functions have the interpretation of marginal cost functions; see, for example, Mussa and Rosen (1978) and Bulow and Roberts (1989). The weight \(1 - \alpha\) in the weighted virtual type functions then corresponds to the weight given to producer or consumer surplus under Ramsey pricing (see, for example, Bulow and Roberts, 1989). For any \(\alpha \in [0, 1]\), we let \(\Phi_\alpha(v)\) and \(\Gamma_\alpha(c)\) respectively denote the weighted ironed virtual valuation and cost functions.\(^4\) We also let \(\Phi(v) := \Phi_1(v)\) and \(\Gamma(c) := \Gamma_1(c)\) denote the virtual type functions that have weight of \(\alpha = 1\) on revenue.

![Figure 1: An illustration of the density functions \(f_\nu\) and \(g_\nu\) for a niche market.](image-url)

In the market for a niche product with parameter \(\nu \in (0, 1)\) we assume that buyer values \(v \in [a_\nu, 1]\) with \(a_\nu < 0\) are drawn from a distribution \(F_\nu\) with density \(f_\nu\) that has full support on \([a_\nu, 1]\) and seller costs \(c \in [0, b_\nu]\) with \(b_\nu > 1\) are drawn from a distribution \(G_\nu\) with density \(g_\nu\) that has full support on \([0, b_\nu]\). We further assume that \(F_\nu(0) = 1 - G_\nu(1) = \nu\) holds for

\(^4\)The ironed virtual type functions are the marginal revenue and marginal cost functions associated with the concavified revenue function and the convexified cost of procurement function, respectively; see, for example, Myerson (1981). The ironed virtual type functions are computed as follows. We first introduce functions \(H_F : [0, 1] \to [0, 1]\) and \(H_G : [0, 1] \to [0, 1]\), where \(H_F(x) = x F^{-1}(1-x)\) and \(H_G(x) = x G^{-1}(x)\). We then let \(\overline{H}_F\) denote the upper concave envelope of \(H_F\) and \(\underline{H}_G\) denote the lower convex envelope of \(H_G\). The ironed virtual type functions are then given by \(\overline{\Phi}(v) = \overline{H}_F(x)\big|_{x=1-F(v)}\) and \(\Gamma(c) = \underline{H}_G(x)\big|_{x=G(c)}\), while the weighted ironed virtual type functions are given by \(\overline{\Phi}_\alpha(v) = (1 - \alpha)v + \alpha \overline{\Phi}(v)\) and \(\Gamma_\alpha(c) = (1 - \alpha)c + \alpha \Gamma(c)\). Here, the upper concave envelope (or concavification) or a given function is the smallest concave function that is weakly larger than the given function at every point in its domain. The lower convex envelope of a given function is the largest convex function that is weakly less than the given function at every point in its domain.
all $\nu \in (0,1)$ and that, for all $v \in [0,1]$ and $c \in [0,1]$, 

$$\frac{F_\nu(v) - \nu}{1 - \nu} = F(v) \quad \text{and} \quad \frac{G_\nu(c)}{1 - \nu} = G(c).$$

That is, in a market for a niche product with parameter $\nu \in (0,1)$, buyers have a value $v \in [a_\nu, 0)$ with probability $\nu \in (0,1)$ and a value $v \in [0,1]$ with probability $1 - \nu$. Conditional on $v \in [0,1]$, buyers values are distributed according to $F$. Similarly, sellers have a cost $c \in (1, b_\nu]$ with probability $\nu$ and a cost $c \in [0,1]$ with probability $1 - \nu$. Conditional on $c \in [0,1]$, sellers costs are distributed according to $G$. See Figure 1 for an illustration. Due to the truncation invariance of the virtual type functions, for any $\alpha \in [0,1]$, $\nu \in [0,1]$, $v \in [0,1]$ and $c \in [0,1]$, we have 

$$\Phi_\alpha(v) = v - \alpha \frac{1 - F_\nu(v)}{f_\nu(v)} \quad \text{and} \quad \Gamma_\alpha(c) = c + \alpha \frac{G_\nu(c)}{g_\nu(c)}.$$

This observation will play an important role in our analysis.

We study two extreme cases that encompass both perfectly thin and perfectly thick markets. On the thin end of the spectrum we consider the bilateral trade problem of Myerson and Satterthwaite (1983) which involves exactly one buyer and one seller. On the thick end of the spectrum we consider markets involving a continuum of traders, with an equal mass of buyers and sellers on each side of the market. In this case we look at both the thick Walrasian market, in which there is a benevolent (arguably fictitious) auctioneer who organizes the exchanges and quotes the market clearing price, and the thick market monopoly, where the thick market is organized by a profit-maximizing monopoly that has zero costs.

The setting introduced here provides a sharp illustration of the main insights of this paper. However, the results in Section 3 can be generalized to allow for asymmetric niche product parameters for buyers and sellers (see Appendix B.1) and to allow for the region of overlapping support between the type distributions to vary with $\nu$ (see Appendix B.2). Our setup is general insofar as we impose only mild restrictions on the distributions from which the agents draw their their types. Its tractability is derived from the way we model the niche nature of products, which we do with a single parameter, without imposing any parameteric restrictions on the type distributions.

Of course, niche products can naturally arise in many alternative settings. For example, one can consider type distributions with unbounded support, where products become increasingly niche as probability mass is shifted towards the tails of the type distributions in an appropriate fashion (see Appendix B.3). One can also model niche products by parameterizing the type distributions so that the elasticity of demand and supply increases and the
Walrasian quantity traded decreases as products become increasingly niche (see Appendix B.4).

3 Analysis

For $\nu \in [0, 1)$, let $S^{FB}_1(\nu)$ and $S^{SB}_1(\nu)$ denote first-best and second-best welfare, respectively, in the bilateral trade setting. Similarly, we let $S_\infty(\nu)$ denote welfare per trader pair in the thick Walrasian market. In this section we analyze the thick Walrasian market and the thick market monopoly by relating them to the bilateral trade problem. In particular, we will be interested in studying how $S^{FB}_1(\nu), S^{SB}_1(\nu)$ and $S_\infty(\nu)$ and their ratios vary with $\nu$. The mass product ratios

$$s_1 := \frac{S^{SB}_1(0)}{S^{FB}_1(0)} \quad \text{and} \quad s_\infty := \frac{S_\infty(0)}{S^{FB}_1(0)}$$

with $0 < s_1 < 1 < s_\infty$ provide a natural benchmark. We will also study how consumer surplus per buyer, producer surplus per seller, and social surplus per trader pair vary with $\nu$ and how they compare to $S^{FB}_1(\nu)$ when the thick market is organized by a profit-maximizing monopoly.

3.1 Thin markets

We begin by analyzing the bilateral trade problem. As noted, conditional on having both $v \in [0, 1]$ and $c \in [0, 1]$, agents’ type distributions (and hence agents’ virtual type functions) do not vary with the parameter $\nu$. Consequently, the first-best mechanism and second-best mechanisms do not depend on $\nu$ and we have $S^{FB}_1(\nu) = (1 - \nu)^2 S^{FB}_1(0)$ and $S^{SB}_1(\nu) = (1 - \nu)^2 S^{SB}_2(0)$, where $(1 - \nu)^2$ is the probability that $v \in [0, 1]$ and $c \in [0, 1]$. More generally, for any $\alpha \in [0, 1]$ we can consider the mechanism that maximizes a convex combination of social welfare and designer profit, where $\alpha$ is the weight on the designer’s profit. Letting $S^\alpha_1(\nu)$ denote welfare under this mechanism, we have the following proposition.

**Proposition 1.** For any $\alpha \in [0, 1]$ and $\nu \in [0, 1)$, we have $S^\alpha_1(\nu) = (1 - \nu)^2 S^\alpha_1(0)$, where $S^\alpha_1(0) = \mathbb{E}[(v - c)Q^\alpha(v, c)]$ and $Q^\alpha(v, c) = 1(\Phi_\alpha(v) \geq \Gamma_\alpha(c))$. Consequently, the ratio $\frac{S^\alpha_1(\nu)}{S^{FB}_1(\nu)}$ does not vary with $\nu$.

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5As shown by Myerson and Satterthwaite (1983), first-best trade is not possible when the agents are privately informed about their values and costs, their interim incentive compatibility and individual rationality constraints have to be satisfied and the mechanism must not run a deficit. Moreover, by assumption, full trade is not optimal in this setting.

6The impossibility theorem of Myerson and Satterthwaite (1983) implies $s_1 < 1$. Because our assumptions imply that full trade is not optimal in this setting, we also have $s_\infty > 1$. 

7
The class of mechanisms considered in Proposition 1 is equivalent to the class of mechanisms that implement Ramsey pricing. This class of mechanisms traces out a frontier characterizing the optimal tradeoff between revenue and welfare, encompassing welfare maximization (the first-best mechanism), welfare maximization subject to budget balance (the second-best mechanism) and profit maximization.

In some applications, other mechanisms, such as the trade sacrifice mechanism of McAfee (1992), may be more practical. With that in mind, we have the following extension of Proposition 1 to the posted-price mechanism of Hagerty and Rogerson (1987), which is what the trade sacrifice mechanism of McAfee (1992) specializes to when there is only one buyer and one seller. Letting $S_{HR}^1(\nu)$ denote Hagerty-Rogerson welfare in the bilateral trade problem we have

$$S_{HR}^1(\nu) = (1 - \nu)^2(1 - F(p))G(p)\mathbb{E}[v - c|v \geq p, c \leq p] = (1 - \nu)^2S_{FB}^1(0),$$

showing that the ratio $\frac{S_{HR}^1(\nu)}{S_{FB}^1(\nu)}$ is constant.

3.2 Thick Walrasian markets

We now analyze thick markets involving a continuum of traders, starting with thick Walrasian markets. Analogously to the case involving bilateral trade, the market clearing price $p$ is independent of $\nu$ and is such that $1 - F(p) = G(p)$. Letting $w = 1 - F(p) = G(p)$ denote the Walrasian quantity in a market for mass products (strictly speaking, the probability that any given agent trades in an efficient thick market, conditional on its type being between 0 and 1), the Walrasian quantity in a market for niche products is given by $w(1 - \nu)$. Welfare per trader pair in the thick Walrasian market is then

$$S_{\infty}(\nu) = w(1 - \nu)\mathbb{E}[v - c|v \geq p, c \leq p] = (1 - \nu)S_{\infty}(0).$$

This setup and the role of the niche product parameter $\nu$ in thick Walrasian markets is illustrated in Figure 2.

Combining all of this with our analysis from the previous section, we have the following proposition.

**Proposition 2.** For any $\nu \in [0, 1)$ we have $\frac{S_{\infty}(\nu)}{S_{FB}^1(\nu)} = \frac{s_{\infty}}{s_{FB}^1(\nu)} > 1$ and hence $\lim_{\nu \to 1} \frac{S_{\infty}(\nu)}{S_{FB}^1(\nu)} = \infty$.

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7 Under Ramsey pricing social welfare is maximized subject to the constraint that the mechanism generates profit of at least $k$. The second-best mechanism corresponds to Ramsey pricing with $k = 0$. This class of mechanisms is also equivalent to the class of mechanisms that maximize profit subject to the constraint that some minimal level of welfare is achieved. See Wilson (1993) and Bulow and Roberts (1989).
Propositions 1 and 2 provide a formalization of the importance of avoiding the double coincidence of wants problem for niche products. As is well known from the double auctions literature, the incentive cost of small markets vanishes quickly as the size of a market increases. Since the second-best mechanism arises as a special case of Proposition 1, this proposition shows that the ratio $S_{SB} / S_{FB}$, which provides an upper bound on the incentive cost of small markets, does not depend on the niche market parameter $\nu$. In contrast, the relative benefits of thick markets, captured by the ratio $S_{\infty} / S_{FB}$, increase in $\nu$ at rate $(1 - \nu)^{-1}$. Intuitively, thin niche markets suffer from a severe double coincidence of wants problem. First-best welfare in the bilateral trade setting is proportional to $(1 - \nu)^2$ because any given agent with a type that lies within the interval $[0, 1]$ is only matched with another such agent with probability $1 - \nu$. In the thick Walrasian market welfare per trader pair is proportional to $1 - \nu$ and any buyer with value $v \geq p$ and any seller with cost $c \leq p$ trades with probability 1.

### 3.3 Thick market monopoly

We now consider a thick market with niche product parameter $\nu$ that is operated by a monopoly market maker. We let $CS_{\infty}^{M}(\nu)$, $PS_{\infty}^{M}(\nu)$ and $S_{\infty}^{M}(\nu)$ denote consumer surplus per buyer, producer surplus per seller and total surplus per trader pair, respectively. In this case it is useful to distinguish whether or not the functions $\Phi(v)$ and $\Gamma(c)$ are increasing. When these functions are increasing, customarily referred to as the regular case, this implies that the marginal revenue and marginal cost functions facing the monopolist are decreasing.
and increasing, respectively. The optimal mechanism under a thick market monopoly then involves posting prices $p_B$ (for buyers) and $p_S$ (for sellers) on both sides of the market. These prices equate marginal revenue and marginal cost and balance the quantity traded. That is, they satisfy

$$\Phi(p_B) = \Gamma(p_S) \quad \text{and} \quad 1 - F(p_B) = G(p_S). \quad (1)$$

To see this, notice that if the monopoly trades the quantity $q \in [0, 1]$ at market clearing prices $p_B = F^{-1}(1 - q)$ and $p_S = G^{-1}(q)$, its profit maximization problem is

$$\max_{q \in [0, 1]} (F^{-1}(1 - q) - G^{-1}(q))q, \quad (2)$$

which yields the first-order condition

$$\Phi(F^{-1}(1 - q)) - \Gamma(G^{-1}(q)) = \Phi(p_B) - \Gamma(p_S) = 0.$$

The second-order condition is satisfied if $\Phi(v)$ and $\Gamma(c)$ are increasing, proving that the first-order condition characterizes a maximum and hence that the prices in (1) are optimal and unique. Moreover, they are independent of $\nu$ and such that $0 < p_S < p_B < 1$. Let $m = G(p_S) = 1 - F(p_B)$ denote the probability that any given buyer or seller trades under the thick market monopoly, conditional on having a value or cost between 0 and 1. The unconditional probability of trading is then $m(1 - \nu)$. Accordingly, in the regular case, consumer surplus per buyer and producer surplus per seller under the thick market monopoly are

$$CS^M_\infty(\nu) = m(1 - \nu)\mathbb{E}_F[v - p_B|v \geq p_B] \quad \text{and} \quad PS^M_\infty(\nu) = m(1 - \nu)\mathbb{E}_G[p_S - c|c \leq p_S].$$

Moreover, the monopoly’s profit per trader pair is $m(1 - \nu)(p_B - p_S)$ and consequently total surplus per trader pair is given by

$$S^M_\infty(\nu) = CS^M_\infty(\nu) + PS^M_\infty(\nu) + m(1 - \nu)(p_B - p_S).$$

More generally, if the type distributions are not restricted to be regular, we can apply the analysis of Loertscher and Muir (forthcoming) to obtain similar expressions for consumer surplus, producer surplus and the monopoly’s profit per trader pair. This yields the following proposition.

**Proposition 3.** For the thick market monopoly, there exists a $\hat{\nu} < 1$ such that for all $\nu > \hat{\nu}$,

$$CS^M_\infty(\nu) > S^F_1(\nu) \quad \text{and} \quad PS^M_\infty(\nu) > S^F_1(\nu).$$
Moreover, \( \lim_{\nu \to 1} \frac{CS^M(\nu)}{S^M_1(\nu)} = \lim_{\nu \to 1} \frac{PS^M(\nu)}{S^M_1(\nu)} = \infty. \)

In markets for products that are sufficiently “niche” both consumer surplus per buyer and producer surplus per seller under a thick market monopoly exceed total surplus under first-best under bilateral trade, and as \( \nu \) approaches 1, the ratio of consumer surplus per buyer and producer surplus per seller under the thick market monopoly over first-best welfare in bilateral trade diverge to infinity. Of course, because social surplus is larger than the sum of consumer and producer surplus, Proposition 3 also implies that social surplus per trader pair under the thick market monopoly over first-best welfare in the bilateral trade problem also diverge to infinity as \( \nu \) approaches 1. As an illustration, assume that \( F \) and \( G \) are uniform. Then \( CS^M_{\infty}(0) = PS^M_{\infty}(0) = 1/32 \) and \( S^F_{1B}(0) = 1/6. \) Using (7), this means that for any \( \nu > 13/16, \) the thick market monopoly outperforms first-best bilateral trade in the sense that consumer surplus per buyer and producer surplus per seller are each larger than social surplus under first-best in bilateral trade. The sum of consumer surplus per buyer and producer surplus per seller under the thick market monopoly exceeds first-best bilateral trade welfare for all \( \nu \) larger than 5/8. Moreover, if one were to adopt a social surplus perspective and also take the monopoly’s profit into account, the monopoly would outperform first-best bilateral trade even with mass products since social surplus under the thick market monopoly is 3/16, which exceeds \( S^F_{1B}(0) = 1/6. \)

An interesting and important question is whether, relative to a thick Walrasian market, a thick market monopoly is more harmful for consumers and producers with niche or with mass products. As we show next, the harm from monopolies that intermediate thick market does not depend on the nature of the product. Letting \( CS_{\infty}(\nu) \) and \( PS_{\infty}(\nu) \) respectively denote consumer surplus per buyer and producer surplus per seller in a thick Walrasian market we have

\[
CS_{\infty}(\nu) = w(1 - \nu)E[v - p | v \geq p] \quad \text{and} \quad PS_{\infty}(\nu) = w(1 - \nu)E[p - c | c \leq p]
\]

and the following proposition.

**Proposition 4.** The ratios \( \frac{CS^M(\nu)}{CS_{\infty}(\nu)}, \frac{PS^M(\nu)}{PS_{\infty}(\nu)} \) and \( \frac{S^M(\nu)}{S_{\infty}(\nu)} \) are finite and independent of \( \nu \) for \( \nu \in [0,1). \)

Proposition 4 states an invariance result for thick markets: that the severity of monopoly harm does not vary with \( \nu. \) This parallels the invariance result for bilateral trade as stated in Proposition 1 which shows that the severity of the incentive problem for thin products is in-

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8This is a point first noted in Loertscher et al. (2021).
dependent of the nature of the product. Like Proposition 1, the results stated in Proposition 4 are driven by the truncation invariance of the virtual type functions.

Proposition 4 has two potentially important policy implications. First, it means that the justification for governments to intervene or not to intervene in thick monopoly markets is the same for niche and for mass products. Second, in combination with Proposition 3, it implies that for \( \nu \) sufficiently large, the consumer and producer benefits from thick market monopolies relative to thin markets are first-order, while the harm from monopolies relative to an efficient thick market is second order.

4 Discussion

We now provide a brief analysis of the increasing returns to scale from market making and show that markets for niche products exhibit greater returns to scale. We also show that mass products naturally mitigate the market power of monopoly market makers faced with competing bilateral exchanges, whereas niche products do not. This provides a rationale for more regulatory scrutiny for thick market monopolies for niche products than for mass products.

4.1 How big are the returns to scale in market making?

We begin by analysing the returns to scale in market making. Specifically, we now consider markets for niche products involving \( n \) pairs of buyers and sellers with independently distributed types. Let \( S_{FB}^n(\nu) \) denote welfare per trader pair in a Walrasian market with \( n \) pairs of buyers and sellers. A natural measure of market thickness is to consider the proportion of the maximum increase in per trader pair surplus

\[
T_n(\nu) := \frac{S_{FB}^n(\nu) - S_{FB}^1(\nu)}{S_{\infty}(\nu) - S_{FB}^1(\nu)}
\]

that is achieved by a market with \( n \) pairs of buyers and sellers. Here, \( S_{\infty}(\nu) - S_{FB}^1(\nu) \) captures the maximum achievable increase in welfare per trader pair as we move from a perfectly thin market with a single pair of traders to a perfectly thick market in the limit as \( n \to \infty \). This measure of market thickness is analogous to that introduced in Loertscher et al. (2021). Accordingly, \( T_{n+1}(\nu)/T_n(\nu) \) provides a natural measure of the returns to scale in market making.

9See, however, Section 4.2 which shows that competing bilateral exchanges are more effective in curbing the market power of thick market monopolies for mass products than for niche products.
In order to compute $T_n(\nu)$ and $T_{n+1}(\nu)/T_n(\nu)$, we start by computing expected welfare $W_n(\nu)$ in a Walrasian market with $n$ pairs of buyers and sellers by exploiting its recursive structure. Specifically, $W_{n+1}(\nu)$ is given by $W_n(\nu)$ plus the expected increase in welfare associated with adding an additional seller to a market with $n$ buyers and $n$ sellers plus the expected increase in welfare associated with adding an additional buyer to a market with $n$ buyers and $n+1$ sellers. Exploiting the analysis of Loertscher et al. (2017) then yields Proposition 5. However, before formally stating this proposition we require some additional notation. Specifically, given a niche market with $n$ buyers and $m$ sellers we let $X = \{v_1,\ldots,v_n,c_1,\ldots,c_m\}$ denote the joint set of trader valuations and costs, $x(1) \leq \cdots \leq x(n+m)$ denote the order statistics of this set and $f_{\nu,i,n,m}(x)$ denote the density of the $i$th order statistic $x(i)$.

**Proposition 5.** Welfare in a Walrasian market with $n+1$ pairs of buyers and sellers satisfies the recursion

$$W_{n+1}(\nu) = W_n(\nu) + (1 - \nu) \int_0^1 \int_0^x (x - c)g(c)f_{\nu,n,n,n}(x) \, dc \, dx$$

$$+ (1 - \nu) \int_0^1 \int_x^1 (v - x)f(v)f_{\nu,n+1,n+1,n+1}(x) \, dv \, dx,$$

with $W_1(\nu) = (1 - \nu)^2 \int_0^1 \int_c^1 (v - c)f(v)g(c) \, dv \, dc$.

For the special case of uniform distributions, we can provide closed-form expressions for welfare, as well as our measures of market thickness and the returns to scale in market making.

**Corollary 1.** If $F$ and $G$ are uniform distributions, then we have

$$W_n(\nu) = \frac{n}{(4n + 2)(2n - 1)} \left( n(2n - 1) + (n(2n + 1) - 1)\nu + \sum_{i=2}^{2n} \nu^i \right)$$

and consequently

$$T_n(\nu) = \frac{2(n - 1)(2n - 1) - 6(n - 1)(2n + 1)\nu^2 + 2(4n^2 - 1)\nu^3 - 6\nu^{2n+1}}{(4n^2 - 1)(2\nu + 1)(1 - \nu)^2}$$

and

$$\frac{T_{n+1}(\nu)}{T_n(\nu)} = \frac{2(n - 1) \left[ 2(1 - \nu)^2(2\nu + 1) + 3\nu^3(1 - \nu^2n) + n(8\nu^3 - 9\nu^2 + 1) \right]}{(2n + 3) \left[ 1 + 3n(\nu^2 - 1) + 3\nu^2 - \nu^3 + 2n^2(\nu - 1)^2(2\nu + 1) - 3\nu^{2n+1} \right]}$$

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Figure 3: Illustration of our measure of market thickness $T_n$ and returns to scale in market making $T_{n+1}/T_n$ for uniform distributions and various values of $\nu$ and $n$.

For mass products (i.e. setting $\nu = 0$), this yields

$$W_n(0) = \frac{n^2}{4n + 2}, \quad T_n(0) = \frac{2(n - 1)}{2n + 1} \quad \text{and} \quad \frac{T_{n+1}(0)}{T_n(0)} = \frac{n(2n + 1)}{2n^2 + n - 3}.$$ 

Figure 3 provides an illustration of the returns to scale in market making, $\frac{T_{n+1}(\nu)}{T_n(\nu)}$, for the special case of uniform distributions and shows that the returns to scale in market making are larger in thinner markets and for niche products. In Appendix B.4 we numerically show that these comparative statics also hold in an alternative model of niche products involving liner virtual types, where products become more niche as the elasticity of both demand and supply increase. Figure 3 highlights the importance of market thickness in markets for niche products, suggesting that it may be undesirable for a regulator to attempt to break up thick markets for such products. However, as we shall see in the next section, niche products may also increase the market power of monopoly market makers.

4.2 Competing bilateral exchanges mitigate market power for mass products

The double coincidence of wants problem is less severe for mass products than for niche products because the probability of finding a trading partner in, say, a bilateral trade setting is larger. This suggests that bilateral trade offers a viable outside option for mass products, and less so for niche products. Since outside options reduce buyers’ willingness to pay and increase sellers’ reservation prices, one would expect that in mass product markets, the market power of a thick market monopoly is constrained by the outside option offered by
bilateral trade. We are now going to formalize this notion by extending the model to allow for the possibility that a perfectly thick large market coexists with bilateral trade.

Without this interpretation being necessary, one can think of the large market monopoly as a digital platform and of buyers and sellers as living in otherwise disconnected, geographical markets such as different towns or countries, each of which is connected to the platform. In line with the main analysis of this paper, we think of these local markets as being characterized by bilateral trade.

To fix ideas, we assume that trade in a bilateral exchange occurs via a posted price mechanism à la Hagerty and Rogerson (1987), where the posted price is the Walrasian price $p$. After learning its type each agent has the option of trading via the thick market monopoly or in a bilateral exchange where trade occurs if and only if the buyer and seller are willing to trade at $p$. For simplicity, that we have a regular mechanism design problem and that $F$ and $G$ exhibit increasing virtual type functions. This implies that if the outside option of agents is 0, posting prices of $p_B$ and $p_S$ is optimal for the monopoly. Even when agents have the outside option of joining a bilateral exchange, we assume that the monopoly is restricted to posting prices.

While there may be multiple equilibria, we focus on the equilibrium with monotone sorting in which for any $p_B > p > p_S$, all buyers with $v \in (\overline{v}, 1]$ and all sellers with $c \in [0, \underline{c})$ trade via the monopoly and all the other types join the bilateral exchanges, where $\overline{v} > p_B$ and $p_S > \underline{c}$ and $1 - F(\overline{v}) = G(\underline{c})$. Under the stipulated assumptions, the respective expected utilities of a buyer of type $v$ and seller of type $c$ from the bilateral exchange is

$$U_B(v) := (1 - \nu)(G(p) - G(\underline{c}))(v - p) \quad \text{and} \quad U_S(c) := (1 - \nu)(F(\overline{v}) - F(p))(p - c),$$

where $v \geq p$ and $p \geq c$. If $v \geq p_B$ and $p_S \geq c$, the payoffs of these agents from going to the monopoly are $v - p_B$ and $p_S - c$, respectively. It follows that $\overline{v}$ and $\underline{c}$ satisfy $\overline{v} - p_B = U_B(\overline{v})$ and $p_S - \underline{c} = U_S(\underline{c})$. Hence, for given $\overline{v}$ and $\underline{c}$, we have $p_B = \overline{v} - U_B(\overline{v})$ and $p_S = \underline{c} + U_S(\underline{c})$, which implies that the monopoly’s spread is

$$p_B - p_S = \overline{v} - \underline{c} - (U_B(\overline{v}) + U_S(\underline{c})). \quad (3)$$

Since it is never optimal to choose $p_B$ and $p_S$ such that $1 - F(\overline{v}) \neq G(\underline{c})$, we can replace $1 - F(\overline{v})$ and $G(\underline{c})$ by the monopoly’s “quantity” $q \in [0, 1]$ (bearing in mind that if it chooses $q$ its quantity traded will be $(1 - \nu)q$). Replacing $F(p)$ by $1 - w$ and $G(p)$ by $w$, the spread

\[10\] If agents have the outside option of joining a bilateral exchanges, the optimal mechanism for the monopoly is not known.

\[11\] Note that since $U'_B(v) < 1$ and $U'_S(c) > -1$ the single crossing condition holds.
Figure 4: The inverse demand and supply functions faced by the monopoly when agents have bilateral trade as an outside option and $F$ and $G$ are uniform distributions.

in (3) thus simplifies to

$$p_B - p_S = (F^{-1}(1 - q) - G^{-1}(q))(1 - (1 - \nu)(w - q)).$$

Figure 4 illustrates the effects of changes in $\nu$ on the inverse demand and supply functions the monopoly faces when the agents have the outside option of participating in a bilateral exchange, where the demand and supply functions are normalized by $1 - \nu$. The monopoly’s profit maximization problem can thus be written

$$\max_{q \in [0,1]} \left( F^{-1}(1 - q) - G^{-1}(q) \right) (1 - (1 - \nu)(w - q)).$$

which has the same logic and structure as that underlying (2). Denote the solution to this problem by $q^*(\nu)$.\textsuperscript{12} Denote the prices associated with $q^*(\nu)$ by $p_B^*(\nu)$ and $p_S^*(\nu)$, we have

$$p_B^*(\nu) = F^{-1}(1 - q^*(\nu)) - (F^{-1}(1 - q^*(\nu)) - p)(1 - \nu)(w - q^*(\nu))$$

and

$$p_S^*(\nu) = G^{-1}(q^*(\nu)) + (p - G^{-1}(q^*(\nu)))(1 - \nu)(w - q^*(\nu)).$$

Let

$$\pi(q) := F^{-1}(1 - q) - G^{-1}(q) \cdot q$$

denote the profit function of the monopoly for mass products when there are no bilateral exchanges.\textsuperscript{12}

\textsuperscript{12}We do not scale this profit by $1 - \nu$ to make sure the maximization problem is well defined even for $\nu = 1$ and to isolate the effects of $\nu$ via the outside options; the objective (4) can be thought of as a normalized profit.
exchanges. Since we assume that $\Phi$ and $\Gamma$ are increasing, $\pi$ is quasiconcave. The following proposition makes the stronger assumption that $\pi$ is concave. A simple sufficient condition for $\pi$ to be concave is that the revenue from selling $q$, $F^{-1}(1-q)q$, is concave and that cost of procuring $q$, $G^{-1}(q)q$, is convex, which holds if $F$ is concave and $G$ is convex.

**Proposition 6.** Assume $\pi(q)$ is concave. Then $q^*(1) = m$ and, for any $\nu \in [0,1)$, $q^*(\nu) > m$. Moreover, $q^*(\nu)$ is decreasing in $\nu$ and the spread $p_B^*(\nu) - p_S^*(\nu)$ is increasing in $\nu$.

Proposition 6 provides a concise formalization of the notion that mass products mitigate market power. As products become more niche and $\nu$ increases, the monopoly’s quantity in the presence of competing bilateral exchanges decreases and its pricing becomes more aggressive. Both effects reduce the sum of consumer and producer surplus at the monopoly. If $F$ and $G$ are symmetric in such a way that $p_B^*(\nu) = 1 - p_S^*(\nu)$ (for example, if $F$ and $G$ correspond to uniform distributions, then the decreasing nature of the spread implies that $p_S^*(\nu)$ decreases in $\nu$ and $p_B^*(\nu)$ increases in $\nu$). Thus, (normalized) consumer surplus and (normalized) producer surplus at the monopoly each decrease in $\nu$.

The fact that $q^*(\nu) > m$ for any $\nu < 1$ is of independent interest. An increase in the monopoly’s quantity decreases the probability of trade in the bilateral exchange and, consequently, the payoffs $U_B(\nu)$ and $U_S(\nu)$. Therefore, the increase in the quantity traded by the monopoly, relative to the model without bilateral exchanges, is driven by a foreclosure motive.

In Appendix B.5 we perform the analogous analysis, assuming that the second-best mechanism operates in the competing exchange and show that the key results derived here continue to hold.

A number of messages emerge from the analysis in this section. First, market power is naturally mitigated with mass products because bilateral trade offers viable outside options. Consequently, “abuse of market” power is less of a concern with thick market monopolies for mass products. By the same token, it is in the interest of the monopoly to drive out even small (bilateral) exchanges because these offer viable outside options and constrain its profit. Of course, in practice and in richer models, the monopoly may take additional or alternative actions to drive out small rivals. This suggests that for mass products, the main concern or focus should be on the foreclosure motive rather than on abuse of market power. Second, for niche products, small bilateral exchanges provide a less viable outside option for traders precisely because the monopoly generates more consumer and producer surplus than bilateral trade for sufficiently large $\nu$. In other words, for niche products there is no natural mitigation of market power in the face of bilateral exchanges. Consequently, abuse of market power is a greater concern and foreclosure of small exchanges is of less concern for
niche products.

5 Conclusions

In this paper, we use an independent private values model to analyze the social costs and benefits of thick markets relative to thin markets. We distinguish between niche and mass products, and model thin markets as bilateral exchanges and thick markets as markets with a continuum of buyers and sellers. We show that whether a product is niche or mass neither affects the severity of the incentive problem in thin markets, nor the severity of the harm to consumers, producers and social surplus under a thick market monopoly relative to an efficient thick market. In contrast, the consumer, producer and social surplus benefits of thick markets relative to thin markets increase as the products become more niche and are unbounded as they become perfectly niche. Thus, for products that are sufficiently niche, the benefits of thick market monopolies are first order and the harm from monopolies relative to efficient thick markets are second order. These results are driven by the fact that for niche products thick markets overcome the double coincidence of wants problem that haunts thin markets. By the same token we show that competing bilateral exchanges constrain the market power of thick market monopolies for mass products but not for niche products. This provides some rationale for increasing regulatory scrutiny of thick market monopolies for niche products.

References


As mentioned in the introduction, the competing bilateral exchanges we analyze differ from the competing exchanges the literature has mostly focused on to date; see, for example, Gehrig (1993), Spulber (2002), Rust and Hall (2003), and Loertscher and Niedermayer (2020). Even though matching in the competing exchange in a model such as Gehrig’s is random, the competing exchange is a thick market because there is a continuum of agents, and these agents participate only if they expect positive surplus from so doing. Hence, even if matching were random, such a thick competing exchange would eliminate the double coincidence of wants problem and would thus be severe competitive constraint for a thick market monopoly for niche products.


Appendix

A  Proofs

A.1 Proof of Proposition 1

Proof. Recall that for any \( \alpha \in [0, 1] \) we let \( \Phi_\alpha(v) \) and \( \Gamma_\alpha(c) \) denote the weighted ironed virtual valuation and cost functions, respectively. Due to the truncation invariance of these functions, they apply regardless of the value of the niche product parameter \( \nu \). The mechanism that maximizes the convex combination of welfare and profit with a weight of \( \alpha \) on profit then has the allocation rule \( Q_\alpha(v, c) = 1(\Phi_\alpha(v) \geq \Gamma_\alpha(c)) \) that induces trade if and only if \( \Phi_\alpha(v) \geq \Gamma_\alpha(c) \). Therefore, for any \( \alpha \in [0, 1] \), the mechanism that implements the allocation rule \( Q_\alpha \) is uniquely pinned down and does not vary with the parameter \( \nu \). For any \( \alpha \in [0, 1] \), we thus have

\[
S_1^\alpha(\nu) = \mathbb{E}_{F_\nu, G_\nu}[(v - c)Q_\alpha(v, c)] \\
= \mathbb{E}_{F_\nu, G_\nu}[(v - c)\mathbb{I}(\Phi(v) - \Gamma(c))] \\
= \int_0^1 \int_0^{\Phi(v)} (v - c)f_\nu(v)g_\nu(c) \, dc \, dv \\
= (1 - \nu)^2 \int_0^1 \int_0^{\Phi(v)} (v - c)f(v)g(c) \, dc \, dv \\
= (1 - \nu)^2 \mathbb{E}_{F, G}[(v - c)Q_\alpha(v, c)] \\
= (1 - \nu)^2 S_1^\alpha(0).
\]

Using \( S_1^{FB}(\nu) = (1 - \nu)^2 S_1^{FB}(0) \) then yields \( \frac{S_1^\alpha(\nu)}{S_1^{FB}(\nu)} = \frac{S_1^\alpha(0)}{S_1^{FB}(0)} \), which shows that this ratio is independent of \( \nu \) as required. \( \square \)

A.2 Proof of Proposition 2

Proof. Using \( S_\infty(\nu) = (1 - \nu)S_\infty(0) \), \( S_1^{FB}(\nu) = (1 - \nu)^2 S_1^{FB}(0) \) and the definition of \( s_1 \) yields \( \frac{S_\infty(\nu)}{S_1^{FB}(\nu)} = \frac{s_1}{1 - \nu} \). Moreover, since \( \nu < 1 \) and \( s_1 > 1 \), we have \( \frac{S_\infty(\nu)}{S_1^{FB}(\nu)} > 1 \). Taking the limit as \( \nu \to 1 \) yields the final statement of the proposition. \( \square \)

\[14\]When \( \alpha = 0 \), we obtain a unique mechanism by taking the welfare-maximizing mechanism that otherwise maximizes the designer’s profit.
A.3 Proof Proposition 3

Proof. For the sake of notational brevity, throughout this proof we write $CS$ and $PS$ instead of $CS^M_\infty$ and $PS^M_\infty$. We have already proven the proposition for the regular case. In general (that is, without imposing regularity) the optimal quantity of the large mass product monopoly, denoted $m$, is such that

$$\Phi(F^{-1}(1 - m)) = \Gamma(G^{-1}(m)),$$

where $\Phi(v) \equiv \Phi_1(v)$ and $\Gamma(c) \equiv \Gamma_1(c)$. It remains to determine the associated pricing mechanism. If $\Phi(F^{-1}(1 - m)) = \Phi(F^{-1}(1 - m))$ and $\Gamma(G^{-1}(m)) = \Gamma(G^{-1}(m))$, the problem is equivalent to the regular case analyzed in Section 3.3, and we are done. There are two additional generic and symmetric cases that need to be considered: (i) $\Phi(F^{-1}(1 - m)) > \Phi(F^{-1}(1 - m))$ and $\Gamma(G^{-1}(m)) = \Gamma(G^{-1}(m))$ and (ii) $\Phi(F^{-1}(1 - m)) = \Phi(F^{-1}(1 - m))$ and $\Gamma(G^{-1}(m)) < \Gamma(G^{-1}(m))$.

In case (i), sellers are paid $p_S = G^{-1}(m)$ and producer surplus is $m(1 - \nu)\mathbb{E}[p_S - c|c \leq p_S]$ (as it is in the regular case). Letting $[F^{-1}(1 - m_2), F^{-1}(1 - m_1)]$ denote the ironed range of $\Phi$ containing $F^{-1}(1 - m)$, buyers with values above $F^{-1}(1 - m_1)$ are always served and pay $p_B^1 = \frac{m_2 - m}{m_2 - m_1} F^{-1}(1 - m_1)$, while buyers with values $v \in [F^{-1}(1 - m_2), F^{-1}(1 - m_1)]$ participate in a lottery where they are served with probability $\frac{v - p_B^1}{m_2 - m_1}$ and pay $p_B^2 = F^{-1}(1 - m_2)$ if they obtain a unit (see Loertscher and Muir forthcoming). Consumer surplus with mass products is (see Loertscher and Muir forthcoming, p.15)

$$CS(0) = \int_0^{m_1} F^{-1}(1 - x)dx + \frac{m - m_1}{m_2 - m_1} \int_{m_1}^{m_2} F^{-1}(1 - x)dx - R(m),$$

where $R(m) = \int_0^m \Phi(F^{-1}(1 - x))dx$.

In case (ii), buyers pay $p_B = F^{-1}(1 - m)$ and consumer surplus is $m(1 - \nu)\mathbb{E}[v - p_B|v \geq p_B]$ (as it is in the regular case). Letting $[G^{-1}(m_1), G^{-1}(m_2)]$ denote the ironed range of $\Gamma$ containing $G^{-1}(m)$, sellers with costs below $G^{-1}(m_1)$ are always severed and are paid $p_S^1 = m(1 - \nu)\mathbb{E}[p_B|p_B \leq p_S^1]$.

15 This is a straightforward generalization of the analysis in Section 3 of Loertscher and Muir forthcoming to two-sided private information.

16 At first glance it might appear as though we need to consider a third case where $\Phi(F^{-1}(1 - m)) > \Phi(F^{-1}(1 - m))$ and $\Gamma(G^{-1}(m)) < \Gamma(G^{-1}(m))$. This case is knife-edge case that requires that the constant regions of the ironed virtual type functions coincide. In this case there are necessarily multiple quantities that are profit-maximizing for the monopoly and at least one such quantity coincides with a previous case. That is, without loss of generality we can restrict attention to mechanisms that involve rationing on at most one side of the market. Within the set of profit-maximizing quantities, consumer and producer surplus are maximized at the largest quantity; see display (8) in Loertscher and Muir forthcoming for consumer surplus (the results for producer surplus are analogous). Our results continue to hold for any monotone selection of the optimal quantity.
\( \frac{m_2-m_1}{m_2-m_1} G^{-1}(m_1) \), while sellers with costs \( c \in [G^{-1}(m_1), G^{-1}(m_2)] \) participate in a lottery where they are given the chance to produce with probability \( \frac{m-m_1}{m_2-m_1} \) and are paid \( p_S = G^{-1}(m_2) \) if they do so. Accordingly, producer surplus is

\[
\mathcal{P}_S(0) = \mathcal{C}(m) - \int_0^{m_1} G^{-1}(x)dx - \frac{m-m_1}{m_2-m_1} \int_{m_1}^{m_2} G^{-1}(x)dx,
\]

where \( \mathcal{C}(m) = \int_0^{m} \Gamma(G^{-1}(x))dx \) is the convex hull of the cost of procuring \( m \) units.

Truncation invariance ensures that cases (i) and (ii) do not vary with \( \nu \in [0,1) \). In particular, denote per buyer consumer surplus by \( CS(\nu) \) and per seller producer surplus by \( PS(\nu) \). Consumer and producer surplus in cases (i) and (ii) are then, respectively,

\[
CS(\nu) = m(1-\nu)\mathbb{E}[v - p_B|v \geq p_B] \quad \text{and} \quad PS(\nu) = (1-\nu)\mathcal{P}_S(0)
\]

and

\[
CS(\nu) = (1-\nu)CS(0) \quad \text{and} \quad PS(\nu) = m(1-\nu)\mathbb{E}[p_S - c|c \leq p_S].
\]

Combining all of these cases we have

\[
\frac{CS(\nu)}{S_{FB}^1(\nu)} = \frac{1}{1-\nu}cs \quad \text{and} \quad \frac{PS(\nu)}{S_{FB}^1(\nu)} = \frac{1}{1-\nu}ps
\]

where

\[
cs := \frac{CS(0)}{S_{FB}^1(0)} \quad \text{and} \quad ps := \frac{PS(0)}{S_{FB}^1(0)}.
\]

Observe that \( cs > 0 \) and \( ps > 0 \). Thus, the ratios are increasing in \( \nu \). Letting

\[
\hat{\nu} = \max\{1-cs, 1-ps\} \quad (7)
\]

the first statement of the proposition follows. The second statement of the proposition follows from taking the relevant limits. \( \Box \)

### A.4 Proof of Proposition 4

**Proof.** The formulas for \( CS^M_\infty(\nu) \) and \( PS^M_\infty(\nu) \) are given in the proof of Proposition 3 and directly proportional to \( 1-\nu \). Moreover, the proof of Proposition 3 also implies that the optimal mechanism of the monopoly does not vary with \( \nu \) and hence monopoly profits are also directly proportional to \( 1-\nu \). Combining this with the expressions for \( CS_\infty(\nu) \), \( PS_\infty(\nu) \) and \( S_\infty(\nu) \) provided in Section 3.3 yield the desired results. \( \Box \)
A.5 Proof of Proposition 5

Proof. Suppose that we have a market with $n$ buyers with valuations $v_1, \ldots, v_n$ and $m$ sellers with costs $c_1, \ldots, c_m$. Adopting standard order statistics notation, we let $c_{(i)}$ denote the $i$th smallest seller cost. It is also convenient to let $v_{[j]}$ denote the $j$th largest buyer value. Loertscher et al. (2017) then make the following useful observation: the Walrasian quantity traded is given by the number of seller costs among the $n$ lowest order statistics from the set $X$, or, equivalently, the number of buyer valuations among the $m$ highest order statistics from $X$. Letting $Q$ denote the Walrasian quantity traded, the Walrasian price for sellers is thus given by $p^S_Q = \min\{c_{(Q+1)}, v_{[Q]}\} = x_{(n+1)}$ and the Walrasian price for buyers is given by $p^B_Q = \max\{c_{(Q)}, v_{[Q+1]}\} = x_{[m+1]} = x_{(n)}$.

If an additional seller with cost $c$ is added to a market with $n$ buyers and $n$ sellers this increases welfare if the additional seller replaces the least efficient trading seller with valuation $c_{(Q)}$ or induces trade with the most efficient inactive buyer with value $v_{[Q+1]}$. That is, the inclusion of this seller increases welfare if and only if $c \leq \max\{c_{(Q)}, v_{[Q+1]}\} = p^B_Q = x_{(n)}$. The expected welfare contribution of the additional seller is thus

$$
E[(x_{(n)} - c) \mathbb{1}(c \leq x_{(n)})] = \int_0^1 \int_0^x (x - c)g_c(c)f_{\nu,n,n,n}(x) \, dc \, dx.
$$

Similarly, if an additional buyer with valuation $v$ is then added to a market with $n$ buyers and $n + 1$ sellers, this increases welfare if the additional buyer replaces the least efficient trading buyer with valuation $v_{[Q]}$ or induces trade with the most efficient inactive seller with cost $c_{(Q+1)}$. That is, the inclusion of this buyer increases welfare if and only if $v \geq \min\{c_{(Q+1)}, v_{[Q]}\} = p^S_Q = x_{(n+1)}$. The expected welfare contribution of the additional buyer is thus

$$
E[(v - x_{(n+1)}) \mathbb{1}(v \geq x_{(n+1)})] = \int_0^1 \int_x^1 (v - x)f_c(v)f_{\nu,n+1,n,n+1}(x) \, dv \, dx.
$$

Putting all of this together yields the proposition statement. \qed
A.6 Proof of Corollary 1

Proof. Combining

\[ f_{\nu,n,n,n}(x) = \sum_{i=0}^{n-1} (n-i) \binom{n}{i} f_{\nu}(x) F(x,\nu)^i (1-G_{\nu}(x))^{n-i} G_{\nu}(x)^{n-i} \]

\[ + \sum_{i=0}^{n-1} (n-i) \binom{n}{i} g_{\nu}(x) (1-F_{\nu}(x))^i G_{\nu}(x)^{n-i} (1-G_{\nu}(x))^{-i+n-1} \]

and

\[ f_{\nu,n+1,n+1,n+1}(x) \]

\[ = \sum_{i=0}^{n} (n-i+1) \binom{n+1}{i} f(x,\nu) F(x,\nu)^i (1-G(x,\nu))^{n-i} G(x,\nu)^{n-i} \]

\[ + \sum_{i=0}^{n-1} (n-i) \binom{n}{i} \binom{n+1}{i+1} g(x,\nu) (1-F(x,\nu))^{i+1} G(x,\nu)^i F(x,\nu)^{n-i} (1-G(x,\nu))^{-i+n-1}. \]

with results of Proposition 5 yields the desired expressions. □

A.7 Proof of Proposition 6

Proof. We start by noting that the profit function in (4) can be rewritten

\[ \pi(q)(1-(1-\nu)(w-q)). \]

The first-order condition for a maximum is therefore

\[ 0 = \pi'(q^*(\nu))(1-(1-\nu)(w-q^*(\nu))) + (1-\nu)\pi(q^*(\nu)). \]

Observe that for any \( \nu < 1, (1-\nu)\pi(q^*(\nu)) > 0 \), which implies \( \pi'(q^*(\nu)) < 0 \). Since \( \pi \) is concave, this in turn implies that for any \( \nu < 1, q^*(\nu) > m \) and \( q^*(1) = m \). Moreover, the second-order condition for a maximum is satisfied whenever the first-order condition holds.

Differentiating the first-order condition and dropping the argument of \( q^*(\nu) \) yields

\[ [\pi''(q^*)(1-(1-\nu)(w-q^*)) + 2(w-q^*)\pi'(q^*)] \frac{dq^*}{d\nu} + \pi'(q^*)(w-q^*-1) = 0. \]
which implies that
\[ \pi''(q^*)(1 - (1 - \nu)(w - q^*)) \frac{dq^*}{d\nu} + \pi'(q^*)[(w - q^*) + (1 - \nu)\frac{dq^*}{d\nu}] - \pi(q^*) + (1 - \nu)\pi'(q^*)\frac{dq^*}{d\nu} = 0, \]
which implies that
\[ [\pi''(q^*)(1 - (1 - \nu)(w - q^*)) + 2(1 - \nu)\pi'(q^*)]\frac{dq^*}{d\nu} + \pi'(q^*)(w - q^*) - \pi(q^*) = 0 \]
and hence
\[ \frac{dq^*}{d\nu} = -\frac{\pi'(q^*)(w - q^*) - \pi(q^*)}{\pi''(q^*)(1 - (1 - \nu)(w - q^*)) + 2(1 - \nu)\pi'(q^*)}. \]
Since \( \pi \) is concave (which implies that \( \pi'' \leq 0 \)), \( \pi' < 0 \) and \( q^* \leq m \) we have \( \pi''(q^*)(1 - (1 - \nu)(w - q^*)) + 2(1 - \nu)\pi'(q^*) < 0 \). Moreover, since \( \pi' < 0 \), we have \( \pi'(w - q^*) - \pi < 0 \). Putting all of this together shows that \( \frac{dq^*}{d\nu} < 0 \) as required.

We are left to establish that the spread \( p^*_B(\nu) - p^*_S(\nu) \) is increasing in \( \nu \). To see this, let
\[ \pi^{BT}(q, \nu) := (F^{-1}(1 - q) - G^{-1}(q))(1 - (1 - \nu)(w - q))q \]
be the profit function in the presence of bilateral exchanges. A revealed preference argument shows that \( \pi^{BT}(q^*(\nu), \nu) \) is increasing in \( \nu \). To see this, consider \( \nu_0 < \nu_1 \). Then because the monopoly could keep the quantity at \( q^*(\nu_0) \) when the parameter is \( \nu_1 > \nu_0 \), we have
\[ \pi^{BT}(q^*(\nu_1), \nu_1) > \pi^{BT}(q^*(\nu_0), \nu_1) \]
\[ = (F^{-1}(1 - q^*(\nu_0)) - G^{-1}(q^*(\nu_0)))(1 - (1 - \nu_1)(w - q^*(\nu_0)))q^*(\nu_0) \]
\[ > (F^{-1}(1 - q^*(\nu_0)) - G^{-1}(q^*(\nu_0)))(1 - (1 - \nu_0)(w - q^*(\nu_0)))q^*(\nu_0) \]
\[ = \pi^{BT}(q^*(\nu_0), \nu_0). \]

Hence, \( \pi^{BT}(q^*(\nu), \nu) \) is increasing in \( \nu \). By definition,
\[ \pi^{BT}(q^*(\nu), \nu) = (p^*_B(\nu) - p^*_S(\nu))q^*(\nu). \]
Since \( q^*(\nu) \) decreases in \( \nu \), \( p^*_B(\nu) - p^*_S(\nu) \) must increase in \( \nu \) for \( \pi^{BT}(q^*(\nu), \nu) \) to be increasing in \( \nu \). \( \square \)
B Extensions and robustness

The setup presented in Section 2 was constructed so that the virtual valuation and cost functions were invariant to the niche product parameter $\nu$. This feature together with the symmetry of the setup simplified the technical aspects of the analysis whilst providing a setting suitable for elucidating the key messages of this paper. However, the main insights and results of this paper extend beyond this setting.

B.1 Asymmetric niche product parameters

The first assumption that we can readily relax is the assumption that a symmetric niche product parameter $\nu$ applies to both sides of the market. Specifically, we can allow for a niche product parameter of $\nu_B$ that applies to the buyers’ side of the market and a parameter of $\nu_S$ that applies to the sellers’ side of the market. In this asymmetric setting, the Walrasian quantity traded and price now vary with both $\nu_B$ and $\nu_S$. However, the virtual type functions are unaffected. We recover results analogous to those stated in Proposition 1, Proposition 2 and Proposition 3 if we take the limit as $\nu_B \to 1$ and $\nu_S \to 1$ in a manner such that the ratio $\nu_B/\nu_S$ is fixed.

B.2 Varying overlapping support of distributions

Our setup in Section 2 was constructed so that for any value of $\nu \in [0, 1)$, the region of overlapping support for the distributions $F_\nu$ and $G_\nu$ was always the interval $[0, 1]$. In this section we show that the spirit of our analysis in Section 3 extends to an alternative setting where the region of overlapping support varies with $\nu$.

We again let $\nu$ denote the niche market parameter and construct the setup so that a product becomes increasingly niche as $\nu$ increases. However, in this alternative setup we take $\nu \in (-1, 0]$. When $\nu = 0$ we now assume that buyer values $v \in [0, 1]$ are drawn from a distribution $F$ with density $f$ that has full support on $[0, 1]$ and seller costs $c \in [0, 1]$ are drawn from a distribution $G$ with density $g$ that has full support on $[0, 1]$. In the market for a niche product with parameter $\nu \in (-1, 0)$ we assume that buyer values $v \in [a_\nu, 1]$ with $a_\nu > 0$ are drawn from a distribution $F_\nu$ with density $f_\nu$ that has full support on $[a_\nu, 1]$ and seller costs $c \in [0, b_\nu]$ with $b_\nu < 1$ are drawn from a distribution $G_\nu$ with density $g_\nu$ that has full support on $[0, b_\nu]$. We further assume that, for all $\nu \in (-1, 0)$, $a_\nu$ and $b_\nu$ are such that $F(a_\nu) = -\nu = 1 - G(b_\nu)$ and that, for all $v \in [a_\nu, 1]$ and $c \in [0, b_\nu]$,

$$F_\nu(v) = \frac{F(v) + \nu}{1 + \nu} \quad \text{and} \quad G_\nu(c) = \frac{G(c)}{1 + \nu}.$$
Notice that this implies that \( a_\nu \) is decreasing in \( \nu \) and \( b_\nu \) is increasing in \( \nu \). We let \( \underline{\nu} \) denote the largest value of \( \nu \in (-1, 0] \) such that \( a_\nu \geq b_\nu \).

In this setup, in a market for a product with niche parameter \( \nu \in (-1, 0) \), buyers values are truncated from below so that buyer values are distributed on the interval \([a_\nu, 1]\) and seller costs are distributed on the interval \([0, b_\nu]\), where \( a_\nu \) is decreasing in \( \nu \) and \( b_\nu \) is increasing in \( \nu \). This implies that increasing \( \nu \) results in less favourable distributions in the sense that, for all \( \nu, \nu' \in (0, 1) \) with \( \nu' > \nu \), \( v \in [0, 1] \) and \( c \in [0, 1] \), \( F_{\nu'}(v) \geq F_\nu(v) \) and \( G_{\nu}(c) \geq G_{\nu'}(c) \). We let \( \Phi \) and \( \Gamma \) respectively denote the virtual valuation and virtual cost function that correspond to the distributions \( F \) and \( G \). The truncation invariance of these functions imply that the same virtual valuation and virtual cost functions are valid for any \( \nu \in (-1, 0) \), on the appropriately restricted domain. Observe that for \( \nu \leq \nu \), the two supports do not overlap. This implies that full trade is efficient and the first-best outcome is possible in the bilateral trade problem. Consequently, for \( \nu \leq \nu \), the Walrasian quantity traded is 1 and

\[
\frac{S_1^{SB}(\nu)}{S_1^{FB}(\nu)} = \frac{S_\infty(\nu)}{S_1^{FB}(\nu)} = 1.
\]

Thus, there are no benefits from thicker markets.

For all \( \nu > \nu \) we have \( a_\nu < b_\nu \). Since the distribution supports overlap in this case, full trade is not efficient and the impossibility result of Myerson and Satterthwaite (1983) holds. Recall that for a given \( \alpha \in [0, 1] \), we let \( \Phi_\alpha(v) \) and \( \Gamma_\alpha(c) \) denote, respectively, the weighted ironed virtual valuation and cost functions and \( Q_\alpha(v, c) = \mathbb{1}(\Phi_\alpha(v) \geq \Gamma_\alpha(c)) \) denote the allocation rule that induces trade if and only if \( \Phi_\alpha(v) \geq \Gamma_\alpha(c) \). Recall also that the second-best mechanism maximizes equally weighted ex ante expected social surplus subject to incentive compatibility, individual rationality and no-deficit constraints. This mechanism is therefore characterized by the unique value of \( \alpha \) such that the allocation rule \( Q_\alpha(v, c) \) generates zero budget surplus. That is, the second-best mechanism is characterized by the unique value \( \alpha^*_\nu \) satisfying

\[
\mathbb{E}_{F_\nu, G_\nu}[(\Phi(v) - \Gamma(c))Q_\alpha(v, c)] = 0.
\]

In the setup from Section 2, the second-best mechanism (and hence \( \alpha^*_\nu \)) was invariant to \( \nu \). Here, as \( \nu \) increases in value beyond \( \nu \), the Walrasian quantity traded \( w(\nu) \) will decrease in \( \nu \) and \( \alpha^*_\nu \) will become strictly positive and monotonically increase in \( \nu \). Formally, we have the following result.

**Proposition B.1.** The parameter \( \alpha^*_\nu \) that characterizes the second-best mechanism increases in \( \nu \in (-1, 0] \) with \( \alpha^*_\nu = 0 \) for all \( \nu \leq \nu \). Moreover, there exists \( \nu < 0 \) such that \( \alpha^*_\nu = \alpha^*_0 \) for
all $\nu \geq \nu$. 

Proof. Let $\nu, \nu' \in (-1, 0]$ with $\nu' > \nu$. Let $R_1^\alpha(\nu)$ denote revenue under the allocation rule $Q^\alpha$. Then by construction we have

$$R_1^\alpha(\nu) = 0$$

and

$$R_1^\alpha(\nu') = \int_0^1 \int_0^1 (\Phi(v) - \Gamma(c)) \mathbb{1}(\Phi_{\alpha^*}(v) \geq \Gamma_{\alpha^*}(c)) \, dF_{\nu'}(v) \, dG_{\nu'}(c).$$

Since the integrand $(\Phi(v) - \Gamma(c)) \mathbb{1}(\Phi_{\alpha^*}(v) \geq \Gamma_{\alpha^*}(c))$ is increasing in $v$ and decreasing in $c$, the distribution $F_{\nu}$ first-order stochastic dominates the distribution $F_{\nu'}$ and the distribution $G_{\nu'}$ first-order stochastic dominates the distribution $G_{\nu}$, we have

$$R_1^\alpha(\nu') \leq R_1^\alpha(\nu) = 0.$$

Hence, $\alpha_{\nu'}^* \geq \alpha_{\nu}^*$ as required. Since full trade is optimal for any $\nu \leq \nu$, we have $\alpha_{\nu}^* = 0$ for all $\nu \leq \nu$. Moreover, by the impossibility result of Myerson and Satterthwaite (1983), $\alpha_0^* > 0$. This implies that when $\nu = 0$, there exists cutoff types $\nu_{SB} > 0$ and $\nu_{SB}^c < 1$ such that any buyer with $v \leq \nu_{SB}$ and any seller with $c \geq \nu_{SB}^c$ never trade under the second-best mechanism. Thus, setting $\overline{\nu} = \min\{\nu \in (-1, 0) : a_{\nu} \leq \nu_{SB}, b_{\nu} \geq \nu_{SB}^c\}$ we have $\alpha_{\nu}^* = \alpha_0^*$ for all $\nu \geq \overline{\nu}$ as required.

Proposition B.1 implies that $\frac{S_1^{SB}(\nu)}{S_1^{FB}(\nu)}$ decreases in $\nu$. Since $w(\nu)$ is less than 1 and decreasing $\nu$, it also follows that $\frac{S_{\infty}(\nu)}{S_1^{SB}(\nu)}$ increases in $\nu$. Interestingly, $\alpha_{\nu}^*$ will cease increasing in $\nu$ before $\nu$ reaches 0, that is, before $a_{\nu} = 0$ and $b_{\nu} = 1$. Indeed, letting $\alpha^*$ denote the second-best mechanism parameter that corresponds to the case $\nu = 0$, we have

$$\alpha_{\nu}^* = \alpha^*$$

for all $\nu \geq \max\{\nu_0, \nu_1\}$, where $\nu_0$ and $\nu_1$ are such that $\Phi_{\alpha^*}(a_{\nu_0}) = 0$ and $\Gamma_{\alpha^*}(b_{\nu_1}) = 1$. For example, when $F$ and $G$ are uniform, we have $\nu_0 = \nu_1 = 1/4$ with $a_{\nu_0} = 1/4$ and $b_{\nu_1} = 3/4$.

To summarize, this extension merely increases the complexity of the model without altering the main messages that emerge from the analysis in Section 3.
B.3 Exponential distributions

An alternative way we can model niche products is to consider distributions with unbounded support. We can then create increasingly niche products by shifting probability mass to towards the tails of the distributions in an appropriate fashion. For example, suppose we take \( v \in [0, \infty) \) with \( F(v) = 1 - e^{-v} \) and \( c \in [\log(a), \infty) \) with \( G(c) = 1 - ae^{-c} \), where \( a > 0 \) is a constant. This specification implies that in a perfectly thick market with a continuum of traders the Walrasian price and quantity traded are given by \( p(a) = \ln(1 + a) \) and \( w(a) = 1/(1 + a) \), respectively. Increasing the parameter \( a \) pushes more probability mass towards the right tale of the sellers’ cost distribution and leads to a decrease in the Walrasian quantity. Thus, the parameter \( a \) plays a similar role to the parameter \( \nu \) in the model from Section 2. Expressed in terms of \( a \), we have

\[
S_{FB}^{1}(a) = \begin{cases} 
\frac{1}{2}(a - 2 \ln(a)), & 0 < a \leq 1 \\
\frac{1}{2a}, & a > 1 
\end{cases}
\]

and

\[
S_{\infty}(a) = \ln(1 + a) - \ln(a).
\]

This implies

\[
\frac{S_{\infty}(a)}{S_{FB}^{1}(a)} = \begin{cases} 
\frac{2(\ln(1+a)-\ln(a))}{(a-2\ln(a))}, & 0 < a \leq 1 \\
2a(\ln(1+a)-\ln(a)), & a > 1.
\end{cases}
\]

Since \( a = 0 \) corresponds to having \( w = 1 \) we have

\[
\lim_{a \to 0} \frac{S_{\infty}(a)}{S_{FB}^{1}(a)} = 1.
\]

Moreover, we also have

\[
\lim_{a \to \infty} \frac{S_{\infty}(a)}{S_{FB}^{1}(a)} = 2.
\]

Solving for the second-best mechanism, in this setting we have

\[
\Phi_{\alpha}(v) = v - \alpha \quad \text{and} \quad \Gamma_{\alpha}(c,a) = \alpha \left( \frac{e^c}{a} - 1 \right) + c.
\]

The value \( \alpha^{*}_{a} \) that characterizes the second-best mechanism (see the previous subsection for a more detailed explanation of this) then satisfies

\[
\frac{2}{3} e^{-a} (\alpha + e^{a}(\alpha - 2)\alpha(\text{Chi}(\alpha) - \text{Shi}(\alpha)) - 1) = 0,
\]

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where the functions $\text{Chi}()$ and $\text{Shi}()$ denote the hyperbolic cosine integral and the hyperbolic sine integral, respectively. Numerical calculations then show that the ratio $\frac{S_{SB}^1(a)}{S_{FB}^1(a)}$ is decreasing in $a$ and is below by 0.854367.

### B.4 Linear virtual types

An alternative modelling approach is to consider settings in which products become more niche as the elasticity of supply and demand increases. To fix ideas we consider a setting with linear virtual type functions in which a single parameter $a > 0$ controls the elasticity of both demand and supply, as well as the Walrasian quantity. Specifically, we assume that buyers draw their values $v \in [0, 1]$ from the distribution $F_a(v) = 1 - (1 - v)^a$ and sellers draw their costs $c \in [0, 1]$ from the distribution $G_a(c) = e^c$. This yields a Walrasian quantity of $w(a) = 2^{-a}$ and price of $p = 1/2$. Thus, this model exhibits similar behavior with respect to the parameter $a$ as the previous model does with respect to the parameter $\nu$. Here, as $a$ increases and a product becomes more niche, the demand and supply curves become increasingly elastic and the Walrasian quantity $w(a)$ decreases.

In this setup, the weighted virtual type functions are given by

$$
\Phi_{a,\alpha}(v) = v - \alpha \frac{1 - v}{a} \quad \text{and} \quad \Gamma_{a,\alpha}(c) = c + \alpha \frac{c}{a}.
$$

Although the weighted virtual type functions and hence the ratio $\frac{S_{SB}^1(a)}{S_{FB}^1(a)}$ now vary with the parameter $a$, we can still bound the relative cost of incentives.

**Proposition B.2.** The ratio $\frac{S_{SB}^1(a)}{S_{FB}^1(a)}$ is decreasing in $a$ for $a \geq 0$ and is bounded below by $2/e$.

**Proof.** Routine calculations yield

$$
\frac{S_{SB}^1(a)}{S_{FB}^1(a)} = \frac{4^{-a} \left(\frac{a+1}{2a+1}\right)^{-2a} \Gamma(2a+2)}{(a+1)\Gamma(2a+1)},
$$

where (in a slight abuse of notation) $\Gamma$ now denotes the gamma function. This is decreasing in $a$ for $a \geq 0$ and taking the limit as $a \to \infty$ yields $2/e$. \qed

With regard to the thick Walrasian market, Proposition 2 still holds as stated for this setup if we replace the limit $\nu \to 1$ with the limit $a \to \infty$. For thick market monopoly, in this setting we have linear virtual type functions so the optimal selling mechanism consists of a posted price $p_B(a)$ for buyers and $p_S(a)$ for sellers. Since both the demand and supply schedules become increasingly elastic as $a$ increases, the spread $p_B(a) - p_S(a)$ decreases in
\[ a \] and \( \lim_{a \to \infty} p_B(a) = \lim_{a \to \infty} p_S(a) = p(a) = 1/2. \) Proposition 3 also continues to hold as stated in this setting if we again replace the limit \( \nu \to 1 \) with \( a \to \infty. \)

With regard to the returns to scale in market making, we cannot analytically compute \( T_n \) and \( T_{n+1}/T_n \) in this model. However, the numerical calculations displayed in Figure 5 show that this model exhibits the same comparative statics as those in our baseline model.

### B.5 Competing exchanges: Second-best bilateral trade

In this section we reconsider the analysis from Section 4.2 assuming that the second-best mechanism is used in the competing bilateral exchanges. For this analysis, we restrict ourselves to the case in which \( F \) and \( G \) are uniform.

As before, we focus on the equilibrium with monotone sorting in which all buyers with \( v \in (\overline{v}, 1] \) and all sellers with \( c \in [0, \underline{c}] \) trade via the monopoly and all the other types join the bilateral exchanges. We let \( U_B(v) \) denote the expected utility of a buyer of type \( v \) from the bilateral exchange and \( U_S(c) \) denote that of a seller of type \( c \). Routine calculations show that the second-best mechanism has \( \alpha^* = 1/3 \) and is such that

\[
U_B(v) = \frac{1 - \nu}{32} \left( \overline{v}^2 - 2\overline{v}(\underline{c} + 4v) - 15\underline{c}^2 + 8\overline{c}v + 16v^2 \right)
\]

and

\[
U_S(c) = \frac{1 - \nu}{32} \left( 16c^2 + 8c(\overline{v} - \underline{c} - 4) - 15\overline{v}^2 - 2\overline{v}(\underline{c} - 12) + \underline{c}(\overline{c} + 8) \right).
\]
It again follows that \( \bar{v} \) and \( \zeta \) satisfy \[ \bar{v} - p_B = U_B(\bar{v}) \quad \text{and} \quad p_S - \zeta = U_S(\zeta) \]

and the monopoly’s spread is \[ p_B - p_S = \bar{v} - \zeta - (U_B(\bar{v}) + U_S(\zeta)). \] (8)

Again, noting it is never optimal to choose \( p_B \) and \( p_S \) such that \( 1 - F(\bar{v}) \neq G(\zeta) \), we can replace \( 1 - F(\bar{v}) \) and \( G(\zeta) \) by the monopoly’s “quantity” \( q \in [0,1] \). The monopolist’s profit can then be written

\[ \pi(q) = (1 - 2q - (U_B(\bar{v}) + U_S(\zeta))q = \frac{q}{16}(q - 2q)(9\nu - 6(1 - \nu)q + 7). \]

The corresponding first-order condition that pins down the optimal quantity \( q^* \) is then given by

\[ 7 + 36(q^*)^2(1 - \nu) + 9\nu - 8q^*(5 + 3\nu) = 0. \]

Solving this quadratic equation yields the two solutions

\[ q^*(\nu) = \frac{10 + 6\nu + \sqrt{37 + 102\nu + 117\nu^2}}{18(1 - \nu)}, \quad \frac{10 + 6\nu - \sqrt{37 + 102\nu + 117\nu^2}}{18(1 - \nu)}. \]

Imposing the requirement that \( q^*(\nu) \in [0,1] \) then leaves us with

\[ q^*(\nu) = \frac{10 + 6\nu - \sqrt{37 + 102\nu + 117\nu^2}}{18(1 - \nu)}. \]

Note that in this case \( q^*(\nu) \) is increasing in \( \nu \). The spread of the monopolist is then given by

\[ p_B - p_S = \frac{-99\nu^2 + 3\left(\sqrt{117\nu^2 + 102\nu + 37} - 14\right)\nu + 5\sqrt{117\nu^2 + 102\nu + 37} + 13}{216(1 - \nu)}, \]

Note that as before the spread of the monopolist is increasing in \( \nu \). These comparative statics are illustrated in Figure 6.

\[ ^{17} \text{Note that since } U_B''(v) < 1 \text{ and } U_S''(c) > -1 \text{ the single crossing condition holds.} \]
Figure 6: Equilibrium quantity $q^*(\nu)$ (panel (a)) and the equilibrium spread $p_B^*(\nu) - p_S^*(\nu)$ (panel (b)) as a function of $\nu$ for $F$ and $G$ uniform.