PREFACE TO "BARGAINING OVER RISKY ASSETS"

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When this paper was written, Bob was always there. I started thinking about the problem in his first-year microeconomics class when he was explaining efficient risk-sharing, based on his Theory of Syndicates: "Imagine two farmers on an island, each having a farm on each side of the island. The crop each will harvest depends on which direction the wind will come from. Being risk averse, these farmers would like to share the risk by writing a contract that re-allocates their crop. To see what kind of a contract they would write, we find any Pareto-optimal allocation, by maximizing weighted average of the expected payoffs, and study the property of this allocation." I did not like this. Given that that there is a continuum of such allocations, I thought, these farmers will determine the contract through negotiation; we should find out which contract they would reach in this negotiation, and study the properties of that contract. It was not clear to me that they would even agree on a Pareto-optimal contract. (I couldn't see back then that the set of contracts that the farmers would reach would be more or less what Bob analyzed, unless the bargaining procedure was fixed.) I asked Bob whether there were papers that do this. He referred me to the literature on short-term contracts, which, I thought, was irrelevant. I was curious how bargaining allocates. I tried to apply Rubinstein's technique. It did not work. Since these people were going to consume their crop at a fixed time in the future, it would not matter when they wrote a specific contract; that is, there was no discounting. I was not interested in making negotiation costly, either. It then occurred to me that the uncertainty would be resolved gradually; they would see whether the wind comes from east or west at each day. Depending on where the wind comes from, the threat point would move around, rendering certain contracts (especially the efficient ones) individually irrational, making the farmers impatient to write a contract. On an example, I computed the equilibrium, and showed that there would be an immediate agreement - using an argument based on the fact that concave transformation of martingales are supermartingales. (I could not see that it was simply because the space of contracts was complete.) I showed Bob; he found it neat. Summer came along. Bob found RA work for us. (I worked on disclosure rules in negotiation without obtaining any interesting result.) We formed a reading group, and studied papers on epistemology, making us even more skeptical about equilibrium analysis. It was already raining when I realized that I had to write my

summer paper. Bob spent an entire Saturday morning listening to my various ideas for a summer paper, which I thought I had to write right away. He picked this idea. He told me about the works of Jack Hirshleifer and Al Roth. (Al Roth analyzed the role of risk aversion in various bargaining models. It seemed that my model was a natural model to study the role of risk aversion, and the standard comparative static did not hold there - for a good reason.) I wrote a draft. He read it, and sent me back a very encouraging note. He even advertised around; I received some paper requests from other students, who probably found out that they were misled. I cannot remember how many times I rewrote the paper, every time realizing that it was even simpler than what I thought last time. Each time, he read the paper, and commented on various aspects. He was always extremely encouraging.