

Part III: Study Questions

- (1) Moral hazard in equity contracts is known as the principal-agent problem.
 - a. What is the principal-agent problem?
 - b. Explain how the separation of ownership and control in American corporations might lead to poor management.
- (2) George Akerlof won the Nobel Prize for economics for his analysis of the used car market. His analysis is referred to as the “lemons problem,” because he looked at the problem created by lemons, bad cars, in the used car market.
 - a. Explain how the problem of asymmetric information will result in too many “lemons” being sold and too few peaches, good cars.
 - b. Is this a problem of moral hazard of adverse selection? Explain.
- (3) Suppose that there are two agents and four possible outcomes for tomorrow, sunshine, rain, snow or sleet, i.e. there are four states of nature. Denote the private information set for agent i as PI_i .
 - a. Define the concept of symmetric information and asymmetric information.
 - b. Suppose agent 1 knows that either rain or sunshine is possible tomorrow. And suppose that agent 2 knows that it could rain, snow or sleet. Which agent has more information?
 - c. What is the pooled (shared) information set if the private information sets for agents 1 and 2 are defined as in part (b)?
- (4) When a bank has a shortfall in required reserves, it must do one of four things. List the bank's options.
- (5) Explain the cost of each of the bank's options.
- (6) Explain how holding excess reserves is insurance against incurring the costs listed in question (5).