ECO 301: Money and Banking
Week 10 Homework: Market Failures

Directions: Provide written answers for the following questions and prompts. You may print these sheets and put your answers in the space provided or you may use your own paper to write your answers.

1. Compare the situation in bond markets in which the probability of defaults are known by lenders versus when the probability of default are not known by lenders. How do the demand for each type of bond compare to each other? What is the impact of the asymmetric information on the interest rate on bonds? What is the impact on the quantity of borrowing? What would be the impact on capital investment by businesses? What type of asymmetric information is this?

2. List and describe three ways that lenders try to minimize the problem of adverse selection.

3. In two or three sentences, describe what is moral hazard. In your answer, describe whether it involves uncertainty regarding the borrower before or after the transaction takes place. Describe the impact on the probability of debt default.

4. List and describe three ways lenders try to reduce the problem of moral hazard.

5. Describe how venture capital firms and private equity firms reduce the problems of moral hazard. How are these actions related to information costs? Absent of the actions of such firms, what impact would such information costs have on the market for bonds? What is the impact on the amount of borrowing, interest rate, and amount of business capital investment?

6. In the context of article, "Greek Deal Stirs Moral Hazard Concerns," describe the moral hazard problem created by providing a sovereign debt bailout to Greece. What type of behavior would this encourage and by whom? What would be the impact on the probability of sovereign debt default in the future? What impact would that have on the market for government bonds?

7. What does John Taylor describe as a solution to minimize the moral hazard problem bailing out Greece? What specific policy would you suggest along these lines? Describe how this reduces the likelihood of moral hazard in the future.

8. Consider that when any country using the Euro experiences a financial crisis, it can have a detrimental effect on the value of the currency, which in turn can have a negative effects on the other countries. It has been argued that the introduction of the Euro as a common currency in 1999 created the moral hazard problem in the first place, and that the 2010 sovereign debt crisis was not the beginning. Explain why this may be true.