Incentives, contracts and equilibrium: Introduction

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Financial markets

Allocate resources among agents, across states and through time → equilibrium

Frictions (information asymmetry) → distort equilibrium allocation → inefficiencies

Optimal contracts → designed to mitigate inefficiencies due to frictions

Outline

1) Dynamic optimal contracting

One principal (investor, banker, venture capital fund) + one agent + friction (moral hazard)

Investment opportunity : Design financial contract to avoid credit rationing and ensure that manager's Incentive Constraint (IC) holds

2) Contracts and equilibrium

Many principals, many agents, interact in market to share risk

Financial contracts designed to share risk subjecxt to IC → impacts asset prices