

Advanced Macroeconomics I

ECON 525a - Fall 2009

Yale University

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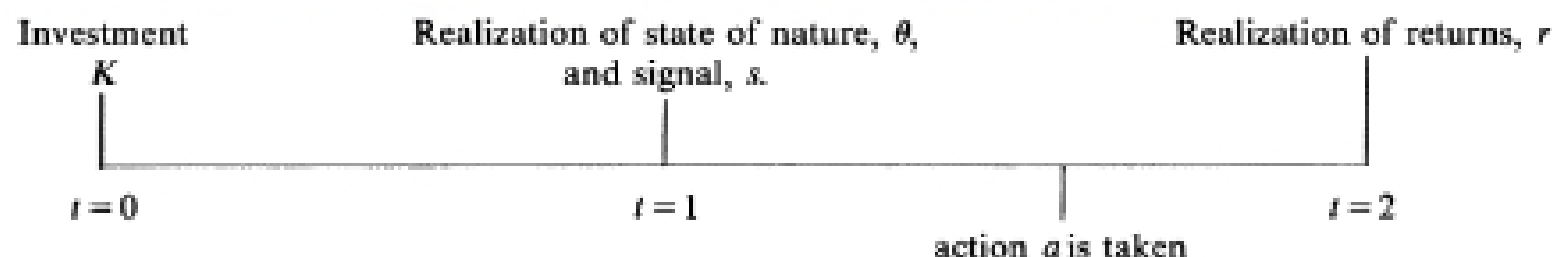
Week 3

Main ideas

- Incomplete contracts call for unexpected situations that need decision to be taken.
- Under misalignment of interests between E and L, a contingent control allocation is optimal.
- Standard debt contract is exactly this,
 - Default. Control goes to L.
 - NO default: Control remains for E.

Model

- E needs K to start a project. L is deep pockets.
- E has all bargaining power. Both are risk neutral.



- Potential misalignment of interests

$$U_E(r, a) = r + l(a, \theta)$$

$$U_L(r, a) = r$$

- Everybody observes θ , but cannot describe it ex-ante.
- There is an informative signal s that can be included in the contract.
- All monetary returns are observable.