

Written Exam for the course

Behavioral Economics and Finance

Master's Course

Date: 17/1/2013

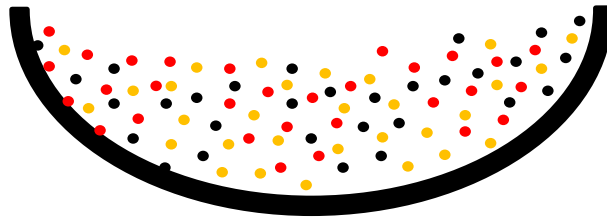
(2-hour, closed book exam)

The exam consists of 3 different questions (with sub-questions).

Good luck.

(1) Ambiguity Aversion:

- (a) Suppose you have an urn containing 20 red balls and 80 other balls that are either black or yellow.



Using this urn, explain the Ellsberg Paradox by constructing two binary choice examples and discussing how people often behave in these choice situations.

- (b) Explain how people's behavior in the above mentioned urn example is related to ambiguity aversion and how Max-Min preferences [Lecture 11] can explain this behavior.
- (c) Sarin and Weber [i.e. *Sarin & Weber (1993), Effects of Ambiguity in Market Experiments, Management Science, 39(5), 602-615*] experimentally study the effect of ambiguity on market prices. Explain their experimental analysis and results.

(2) Distributional concerns

- (a) Formally explain the model of inequality aversion by Fehr and Schmidt (1999) [i.e. *Fehr & Schmidt (1999), A theory of fairness, competition, and cooperation, Quarterly Journal of Economics 114(3), 817-868*]
- (b) Formally explain how people should behave in the dictator game and the ultimatum game given Fehr and Schmidt (1999)'s theory of inequality aversion.
- (c) Explain the lab and field evidence regarding the impact of fairness concerns on the wage effort relation in spot and ongoing work situations as discussed by Fehr et al. (2009) [i.e. *Fehr, Goette and Zehnder (2009), A Behavioral Account of the Labor Market: The Role of Fairness Concerns, Annual Review of Economics, 1(1), 355-384*]

(3) Representativeness and Conservatism

- (a) Explain the representativeness heuristic and why this heuristic might lead to the conjunction fallacy.

- (b)** Explain the conservatism bias.
- (c)** Explain how Barberis et al. (1998) [i.e. *Nicholas Barberis, Andrei Shleifer & Robert Vishny (1998), A model of investor sentiment, Journal of Financial Economics, 49, 307-343*] combine conservatism and representativeness in one model to explain short run under and mid run overreactions.