

Economics 380: Midterm Solutions 2

16 November, 2005

1. One major reason for Microsoft to lease its products is to overcome the Coase conjecture. Microsoft's biggest competitor is arguably themselves. That is, people wait to buy windows anticipating a price cut or a new edition. The fact people intertemporally arbitrage lowers Microsoft's profits. Leasing would overcome this problem since updates my decision to buy today is independent of the leasing price tomorrow.

2. The price you pay for a flight depends upon:

- degree of flexibility for changes and cancellations (2nd degree).
- when you buy your ticket (2nd degree)
- which class you travel in (2nd degree)
- which country you buy your ticket (usually 3rd degree)
- whether you buy your ticket online (2nd degree)
- whether you are a student or not (3rd degree)
- how much you travel, for example, via your miles (2nd degree)
- when you travel (2nd degree)
- whether you buy single or return (2nd degree)

3. Yield management:

(a) An airline would decrease its price if no one buys for a while. Intuitively, if no one buys then the probability of stockout falls as does the opportunity cost of a ticket. Conversely, an airline would increase its price if it sells a lot of tickets (relative to the capacity).

(b) A fixed price scheme would achieve the optimum if: (i) there is little variation in customer's valuations; or (ii) the capacity constraint never binds.

4. Car auctions:

(a) Private value components include the colour, the model, the size of the engine. For these components, a bidder knows their valuation. Common value components include the reliability

of the engine, whether it has been in any crashes, and the amount of rust. For these components, bidder i 's value depends on bidder j 's information (e.g. their view of the quality).

(b) The winners curse states that winning is a bad sign since it means the winning bidder is most optimistic. For example, it could mean that all the other bidders think that the car is unreliable.