Chapter 37:

A company's share price on 1st March is €2.50. The company releases a statement saying that one of the products it manufactures has been removed from sale following the release of an article in a medical journal which associates the product with an increased risk of cancer in young children.

1. Explain what you would expect to happen to the share price of the company as a result of this new information.

Answer:
The information is bad news on the one hand but the company seems to have been proactive in removing the product swiftly. The effect is that the share price is likely to be depressed but how far it goes down depends on the seriousness of the allegations, the number of people involved, what other information comes to light and how the company respond to the situation in the coming weeks. The market will seek to take into account all this information in pricing the share price of the company and the extent to which it believes the information will impact on the future profitability of the business.

2. Is it morally corrupt to use the efficiency of markets to trade contracts in disasters and terrorist events?

Answer:
The answer will depend on the perceived benefits that might arise from such a market in relation to the costs. Is it morally corrupt to use a market to gather additional intelligence (which is after all what it would be) which might prevent serious events from occurring which may claim many lives? Would such a market mean that there would be an increased likelihood of such events occurring or would it encourage more people to share information and intelligence thus help to reduce them? Is there a risk that markets could be manipulated and resources diverted to preventing something which is not going to happen whilst being able to hide plans to cause problems elsewhere?

3. Why is high quality information so important to the efficient working of markets?

Answer:
Decisions of both buyers and sellers rely on high quality accurate information. If information is inaccurate or unreliable then risks assessed would also be inaccurate and decisions would be made based on incorrect information. Resources would not, as a result, be diverted to their most useful purpose and so the market would be inefficient, by definition.

4. Should economics base more of its assumptions on behavioural psychology rather than on rational behaviour?

Answer:
In order to carry out any economic analysis some assumptions have to be made. What may be dangerous is relying on only one type of assumption which may be too far from reality and making economic policy on this type of assumption alone. Assumptions of rationality may have some relevance in certain situations but in others a behavioural approach may be more relevant. The future for economics is to find a way of rationalising our understanding of human behaviour and building these into models that will help better reflect the real world. This is one of the benefits of neuroeconomics, using advances in the understanding of how the brain works to help inform theory and the reasons for the behaviour of 'homoeconomicus'.