

Quiz: Economic Theory of Digital Markets

Day 7A – 20 Questions

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Digital Finance – Intensive Course

Question 1 – Transaction Cost Economics

Ronald Coase's 1937 paper asked: why do firms exist at all, given that markets coordinate production efficiently? His answer was:

- A Firms exist because of government regulation requiring corporate structures
- B Firms exist because the cost of using markets (negotiating, monitoring, enforcing contracts) is positive, and internal organisation can be cheaper for recurring transactions
- C Firms exist because entrepreneurs prefer hierarchy to market relationships
- D Firms exist because technology is too complex for market coordination

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Answer: (B) Coase's insight: if markets were costless, all production would be coordinated through market contracts. Firms exist precisely because transaction costs make internal coordination cheaper for some activities. This is the foundation of Transaction Cost Economics (TCE).

Question 2 – Transaction Cost Types

Williamson (1985) extended Coase by distinguishing three types of transaction costs. Which of the following is NOT one of Williamson's three types?

- A Search and information costs (finding the right counterparty)
- B Bargaining and decision costs (negotiating contract terms)
- C Network externality costs (the cost of low adoption by others)
- D Policing and enforcement costs (monitoring and enforcing the agreement)

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Answer: (C) Williamson's three types are search/information, bargaining/decision, and policing/enforcement costs. Network externality costs are a separate concept from platform economics, not a transaction cost type.

Question 3 – M-Pesa and Transaction Costs

M-Pesa (Kenya, 2007) achieved rapid adoption by reducing which primary transaction cost category for rural users?

- A Bargaining costs – M-Pesa automated the negotiation of exchange rates
- B Enforcement costs – M-Pesa provided dispute resolution for peer disputes
- C Search and physical access costs – the cost of traveling to a bank branch to send or receive remittances
- D Regulatory compliance costs – M-Pesa removed the need for identity verification

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Answer: (C) For Kenyan rural workers, the dominant TC was the physical cost of traveling to urban bank branches to send money home. M-Pesa replaced a multi-day journey with an SMS. This single TC reduction drove adoption from 0 to 10m users in 18 months.

Question 4 – Alipay and TCE

Alipay launched in 2004 as a Taobao escrow service. Which transaction cost does escrow specifically resolve?

- A Search costs – escrow helps buyers find trustworthy sellers faster
- B Bargaining costs – escrow automates price negotiation
- C Enforcement costs – escrow holds payment until delivery is confirmed, eliminating the need to trust an unknown counterparty
- D Network costs – escrow creates a shared payment standard

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Answer: (C) Escrow specifically resolves the enforcement cost: the risk that a counterparty defaults after receiving payment (or goods). By holding funds in a trusted third party until both sides confirm, escrow eliminates the need for prior relationship or legal recourse.

Question 5 – TCE and Platform Design

A fintech startup claims it will “eliminate all transaction costs in real estate transactions.” A TCE-informed analyst would respond:

- A Transaction costs in real estate are already zero, so there is nothing to eliminate
- B Eliminating search costs might increase bargaining costs; optimising one TC type usually creates pressure in another
- C Transaction costs are legally mandated and cannot be reduced by technology
- D Reducing transaction costs always increases market efficiency with no tradeoffs

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Answer: (B) TCE teaches that transaction costs trade off against each other. Reducing search costs (e.g., automated matching) may increase bargaining costs (more counterparties found means more negotiation). “Eliminating all TCs” is a marketing claim; a rigorous analysis identifies which TCs fall and which rise.

Question 6 – Akerlof's Insight

Akerlof (1970) showed that used car markets can collapse even when both good cars (“peaches”) and bad cars (“lemons”) exist. The key mechanism is:

- A Government price controls that prevent clearing at the market price
- B Sellers know the car quality but buyers do not; buyers price at the average, driving good cars out of the market
- C Used cars depreciate too quickly for profitable trade
- D Buyers and sellers disagree about what fair value means

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Answer: (B) Akerlof's insight: asymmetric information (seller knows quality, buyer does not) means buyers price at the expected average. At that price, sellers of good cars withdraw – they know their car is worth more. The remaining pool has lower average quality, buyers reduce their price, more good cars withdraw. Market unravels.

Question 7 – Adverse Selection in Credit

A bank raises loan interest rates in response to rising defaults. Akerlof's framework predicts:

- Ⓐ Raising rates solves the problem because risk-adjusted returns improve
- Ⓑ Raising rates makes adverse selection worse: good borrowers leave first (their risk-adjusted cost increases), leaving a riskier pool, potentially requiring further rate increases
- Ⓒ Raising rates has no effect on the pool quality because borrowers do not change behaviour
- Ⓓ Raising rates improves pool quality by signalling the bank's strength

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Answer: (B) This is the adverse selection spiral. Unlike normal goods, higher prices in credit markets select against the best quality (lowest-risk) buyers, who have the most attractive outside options. The remaining pool is riskier, which may justify further rate increases – a self-reinforcing collapse.

Question 8 – Signaling

Spence (1973) showed that high-ability workers can credibly signal their quality to employers through education, even if education adds no direct productivity. Why does this work?

- A Education directly teaches skills that employers value, making high-ability workers more productive
- B Education is costly for low-ability workers but cheap for high-ability workers; only high-ability workers find it worthwhile, so it is a credible signal
- C Employers legally require education credentials and cannot verify skills otherwise
- D Education works as a network effect: more educated workers attract better employers

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Answer: (B) Spence's key condition: the signal must be costly for low types and cheap for high types (single-crossing property). If both types find education equally costly, everyone would get it and it would stop being informative. Fintech analogy: a 3-month payment history is cheap for reliable users to acquire, costly for unreliable ones.

Question 9 – Ant Group and Alipay

Sesame Credit (Ant Group, 2015) addressed adverse selection in consumer lending by:

- Ⓐ Offering lower interest rates to all borrowers to attract the best-quality pool
- Ⓑ Using 10+ years of Alipay transaction data to build a credit score that reveals borrower quality that banks could not observe
- Ⓒ Requiring borrowers to provide collateral before receiving loans
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Answer: (B) Sesame Credit is a screening mechanism: it uses Ant's proprietary transaction data (spending patterns, social connections, repayment history) to infer credit risk that traditional credit bureaux cannot observe. This directly reduces the adverse selection problem – the lender can now distinguish peaches from lemons.

Question 10 – Screening vs Signaling

Stiglitz and Weiss (1981) proposed credit *rationing* as the equilibrium outcome in credit markets with adverse selection. Rationing means:

- A Banks charge higher rates to risky borrowers until the market clears
- B Some creditworthy borrowers are denied loans at the prevailing rate even when they would pay a higher rate – the bank prefers to ration rather than raise rates
- C Banks lend only to government-guaranteed borrowers
- D Banks require physical collateral in lieu of credit scoring

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Answer: (B) Stiglitz-Weiss rationing: raising rates worsens pool quality (adverse selection), so the bank prefers to keep rates fixed and ration. This is why creditworthy borrowers are sometimes denied loans even at higher rates – it is not irrational, it is optimal given the information problem.

Question 11 – Rochet-Tirole Insight

Rochet and Tirole (2003) showed that in a two-sided market (e.g., a credit card network), the profit-maximising price structure is:

- A Charge both sides equally because fairness maximises adoption
- B Subsidise the side with more elastic demand and charge the side that benefits most from the other side being on the platform
- C Charge the wealthier side (usually merchants) more to extract maximum surplus
- D Charge whichever side is smaller because they have less bargaining power

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Answer: (B) The Rochet-Tirole pricing rule: price to side A depends on A's own-price elasticity and how much B values having more A users. If consumers are elastic (many alternatives) and merchants benefit strongly from having all consumers on the network, the optimal strategy is to subsidise consumers and charge merchants.

Question 12 – Behavioral Foundations: Loss Aversion

Loss aversion (Tversky and Kahneman, 1979) is the empirical finding that losses are weighted approximately λ times as much as equivalent gains in subjective utility. What is the canonical empirical estimate for λ ?

- A) $\lambda \approx 1.0$ (no asymmetry between gains and losses)

Loss aversion is the empirical foundation that turns every UX choice into an economic mechanism.

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- C) $\lambda \approx 5.0$ (extreme avoidance)
- D) λ varies by individual with no central tendency

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Question 13 – Metcalfe's Law

Metcalfe's Law states that the value of a network with n users scales approximately as n^2 . Which of the following correctly states the strategic implication?

- A Two networks of size n are worth exactly the same as one network of size $2n$
- B A network of size $2n$ is twice as valuable as one of size n
- C A network of size $2n$ is approximately four times as valuable as one of size n , creating winner-take-all dynamics once a platform reaches critical mass
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- D Networks grow linearly in value, so steady investment always increases platform value proportionally

Answer: (C) $V(2n) \approx (2n)^2 = 4n^2 = 4 \cdot V(n)$. Doubling users quadruples value. This is why platform competition tips: once one platform gets significantly larger, the value gap widens faster than any competitive response can close.

Question 14 – Tipping and Market Structure

In a two-sided market with strong network effects, the long-run equilibrium is most likely to be:

- Ⓐ A perfectly competitive market with many equally-sized platforms
- Ⓑ A monopoly or tight duopoly, with the larger platform widening its value advantage until switching becomes irrational for most users
- Ⓒ A regulated public utility with prices set by government
- Ⓓ An equilibrium with ten to twenty platforms of similar size

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Answer: (B) Strong network effects with single-homing lead to winner-take-all or tight oligopoly. The largest platform offers the most value; rational users join the largest, widening the gap. PSD2 and open banking regulation attempt to prevent this equilibrium from becoming permanent.

Question 15 – Cross-Side Externalities

In Alipay's two-sided market, which of the following describes a positive cross-side externality?

- A Each new merchant accepting Alipay makes Alipay more valuable to all consumers, and each new consumer makes Alipay more valuable to all merchants
- B Each new Alipay user makes all other users' transactions more expensive due to congestion
- C Merchants and consumers on Alipay compete with each other for lower prices
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Answer: (A) Cross-side (or cross-group) externalities are positive when each side values the presence of the other side. More merchants means consumers can pay more places (consumer value rises). More consumers means merchants can serve more buyers (merchant value rises). This mutual reinforcement is the engine of platform growth.

Question 16 – Schumpeter's Creative Destruction

Schumpeter's concept of "creative destruction" in the context of digital finance means:

- Ⓐ New fintech firms gradually improve existing financial services without displacing incumbents
- Ⓑ New technologies systematically destroy the competitive advantages of existing firms while creating new industries, meaning that dominant position in one technological generation does not guarantee dominance in the next
- Ⓒ Financial crises destroy economic value and create regulatory opportunities
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Answer: (B) Schumpeter: innovation is not a smooth improvement process but a discontinuous replacement of one competitive equilibrium by another. Kodak was destroyed by digital photography despite being excellent at film. Incumbent banks face this risk: superior execution of cheque clearing does not protect them from mobile-first challengers.

Question 17 – Game Theory: Chicken-and-Egg Coordination

Two-sided platform launches face a chicken-and-egg problem because both sides face a coordination game with multiple Nash equilibria (a high-coordination equilibrium where both sides adopt, and a low-coordination equilibrium where neither adopts). Which of the following is NOT a mechanism a platform can use to shift adoption toward the high-coordination equilibrium?

- A) Subsidising one side (e.g., free terminals for merchants, free shipping for consumers)

Solve chicken-and-egg by changing the game's payoffs, not by subsidising both sides into bankruptcy.

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- D) Setting prices below marginal cost on both sides simultaneously

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Question 18 – Robinhood Classification

Using Christensen's framework, Robinhood (zero-commission mobile brokerage, launched 2013) is best classified as:

- A New-market disruption: it initially targeted non-consumers (millennials not using full-service brokerages) with a simpler, cheaper product
- B Low-end disruption: it attacked the least profitable Schwab and Fidelity customers with a worse product
- C Sustaining innovation: it improved the brokerage experience for existing high-value Schwab customers
- D Radical innovation: it created a genuinely new financial product category

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Answer: (A) Robinhood is classic new-market disruption: it created a new pool of investors who did not invest before (non-consumers), using a mobile-first, zero-fee interface far simpler than incumbents. Once it built this base, it has gradually added features (options, crypto, gold accounts) that allow it to move up-market.

Question 19 – Innovator's Dilemma Applied

The “innovator's dilemma” describes why JPMorgan cannot simply build Robinhood. The core dilemma is:

- Ⓐ JPMorgan lacks the technical skills to build mobile applications
- Ⓑ Attacking the low end would cannibalize JPMorgan's high-margin existing clients; rational short-term decisions by existing business units prevent the firm from responding effectively to low-end disruption
- Ⓒ Regulation prevents banks from offering zero-fee brokerage
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Answer: (B) The innovator's dilemma: a rational, well-managed incumbent focuses resources on its highest-margin customers (the logical short-term decision). The disruptive entrant serves a segment the incumbent rationally ignores. By the time the disruptive product improves to threaten the core, the incumbent's internal processes, incentives, and culture are not designed to respond.

Question 20 – Ant Group: Four Lenses

Using all four Day 7A economic lenses (TCE, Akerlof, Rochet-Tirole, Christensen), which statement about Ant Group's expansion from payments into asset management (Yu'e Bao) is correct?

- A TCE: Yu'e Bao reduced the bargaining costs of fund management; Akerlof: it solved adverse selection among fund managers; Rochet-Tirole: it subsidised fund managers; Christensen: it was a sustaining innovation for banks
- B TCE: Yu'e Bao eliminated the access cost of money market funds (minimum investment, branch visit); Akerlof: Ant's data reduced adverse selection in identifying reliable depositors; Rochet-Tirole: the two-sided market between depositors and borrowers was optimised using idle balance data; Christensen: it was new-market disruption targeting consumers who never held money market instruments
- C All four lenses suggest Yu'e Bao had no economic advantage over traditional money market funds
- D TCE and Akerlof apply but Rochet-Tirole and Christensen do not apply to asset management products

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- D TCE and Akerlof apply but Rochet-Tirole and Christensen do not apply to asset management products

Answer: (B) All four lenses apply simultaneously and reinforce each other. This is what makes the Ant Group case powerful: it demonstrates that a single product can exploit multiple economic mechanisms at once, creating compounding competitive advantage that no single-lens analysis would fully predict.