1. a. Cash is a financial asset because it is the liability of the government.
   b. No. The cash does not directly add to the productive capacity of the economy.
   c. Yes. You can buy more goods and services than previously.
   d. If the economy is already operating at full capacity, and you now command the extra purchasing power offered by the $10 billion, then your increased ability to purchase goods must be offset by a decline in the ability of others to purchase goods. Thus, the other individuals in the economy can be made worse off by your discovery.

2. a. The bank loan is a financial liability for Lanni; conversely, Lanni's IOU is the bank's financial asset. The cash Lanni receives is a financial asset. The new financial asset created is Lanni's note (that is, its IOU to the bank).
   b. Lanni transfers financial assets (cash) to its software developers. In return it gets a real asset, the completed software. No financial assets are created or destroyed; cash is simply transferred from one party to another.
   c. Lanni gives the real asset (the software) to Microsoft in exchange for a financial asset, shares in Microsoft. Since Microsoft issues new shares to pay Lanni, this represents the creation of new financial assets.
   d. Lanni exchanges one financial asset (1,500 shares of stock) for another ($120,000). It gives a financial asset ($50,000 cash) to the bank and gets back another financial asset (its IOU). The loan is "destroyed" in the transaction, since it is retired when paid off, and no longer exists.

6. a) Fixed Salary – this arrangement does not align the interests of the managers and the owners. The advantage is that it is a predictable cost. Disadvantages is that the managers does not have any incentive to maximize the wealth of shareholders, except to the degree that he or she will see future salary increase.
   b) Stock in the Firm – This aligns the interests of the managers with the owners as they share a common goal of increasing the share price. If the sale of stock is restricted until some future date, this provides managers with the correct incentive of managing for the long run.
   c) Call options on shares of the firm – This aligns the interests of the owners and managers, as the manager has a levered position in the firm’s stock, and will only get a payoff if the stock goes above the strike price. The potential disadvantage is that the manager will
manage for a short term benefit, rather than for the long run. The manager may be tempted
to engage in questionable practices to try and get the stock price to increase in the short
term.

14. Ultimately, real assets do determine the material well-being of an economy. Nevertheless,
individuals can benefit when financial engineering creates new products that allow them to
manage their portfolios of financial assets more efficiently. Because bundling and
unbundling creates financial products with new properties and sensitivities to various
sources of risk, it allows investors to allocate and hedge particular sources of risk more
efficiently.

15. Financial assets make it easy for large firms to raise capital to finance their investments
in real assets. If General Motors, for example, could not issue stocks or bonds to the
general public, it would have a far more difficult time raising capital. Contraction of the
supply of financial assets would make financing more difficult, increasing the cost of
capital. A higher cost of capital means less investment and lower real growth.