1079-91-288 **Jaeyoung Sung*** (jaeyoungsung@ajou.ac.kr), Department of Financial Enineering, Ajou University, Suwon, Gyunggi-do 443-749, South Korea, and **Xuhu Wan** (imwan@ust.hk), Department of Information Systems, Business Statistics and Operations Mgt., Hong Kong U. of Science and Technology, Clear Water Bay,, Kowloon , Hong Kong. *A General Equilibrium Model of a Multi-Firm Moral-Hazard Economy with Financial Markets.*

We present a general equilibrium model of a moral-hazard economy with many firms and financial markets, where stocks and bonds are traded. Contrary to the principal-agent literature, we argue that optimal contracting in an infinite economy is not about a tradeoff between risk sharing and incentives, but it is all about incentives. Even when the economy is finite, optimal contracts do not depend on principals' risk aversion, but on market prices of risks. We also show that optimal contracting does not require relative performance evaluation, that the second best riskfree interest rate is lower than that of the first best, and that the second-best equity premium can be either higher or lower than that of the first best. Based on these results, we argue that given the volatility of the market portfolio, moral hazard can contribute to the resolution of the riskfree rate puzzle, but unlike the existing literature suggests, our model provides a case where moral hazard can neither help explain nor deepen the equity premium puzzle. (Received January 17, 2012)