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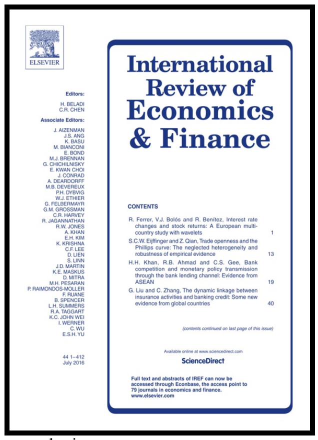

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Production and hedging with optimism and pessimism under ambiguity *

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Abstract: This paper analyzes the optimal production and hedging decisions of a competitive firm holding optimism and pessimism under price ambiguity. We show that the separation theorem remains intact as the firm's optimal output level depends neither on the output price distribution nor on the firm's preferences. Furthermore, the validity of the full-hedging theorem depends on the extent to which the firm is optimistic about the uncertain output price. Notably, we identify a threshold of the firm's optimism level above which it is never optimal for the firm to full-hedge even when an unbiased hedging opportunity is available. Our results suggest how a firm's optimism level and ambiguity degree affect its production and hedging behavior and provide a novel explanation for why firms in practice shy away from full-hedging.

Keywords: Production, Hedging, Ambiguity, Optimism, Pessimism.
JEL Classification Numbers: D21, G02, G32.

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