ECO-HC-4016 Intermediate Microeconomics II [H.L. Ahuja]

Unit 3 Markets with asymmetric information

Asymmetric Information

Asymmetric information means the market situation when the buyers and sellers have a different information while making transaction. Asymmetric information is quite common. Frequently, a seller of a product knows more about its quality than the buyer does. Workers usually know their own skills and abilities better than employers. And business managers know more about their firms' costs, competitive positions, than do the firms' owners.

The implications of asymmetric information about product quality were first analysed by George Akerlof.

Adverse Selection

Adverse selection is a form of market failure resulting when products of different qualities are sold at a single price because of asymmetric information, so that too much of the low-quality product and ~~too~~ little of the high quality product are sold.

Adverse Selection in the Market for Lemons

The important example of market with asymmetric information is the market for used cars. ~~Suppos~~ Suppose two kinds of used cars are available - high quality cars and low-quality cars (lemons). The bad quality cars. (i.e., lemons) quite often break down and require a lot of repairs. However, while the sellers of used cars fully know the quality of their used cars, the buyers

Uncertain about their quality due to lack of complete information. Therefore, the market for used cars is an important example of asymmetric information. All sellers of used cars, whether of good quality or bad quality, claim that their cars are of good quality. The buyers of course cannot know which of the used cars are of good quality and which are just lemons. The buyers being uninformed about the quality of the used cars ~~offered for sale~~ will not willing to pay more than what an average quality used car is worth. This means that the owners of bad quality cars will get price for their used cars more than what they are worth. Since the owners of good quality used cars will not be able to get the price for their better quality cars since the price determined in the markets for used cars will be equal only to what average quality used cars are worth. As a result, the owners of good quality used cars will withdraw their cars from the market. This will reduce the number of used cars in the market. This process of withdrawing from

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the market for used cars will go on until only bad quality used cars, that is, lemons are left for sale in the market. This phenomenon is called adverse selection due to asymmetric information on the part of sellers and buyers the bad quality products drive out the good quality products from the market.

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