4th SEMESTER

CC-8

Unit - 2

ASYMMETRIC INFORMATION

Asymmetric Information is a situation in which a buyer and a seller possess different information about a transaction.

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

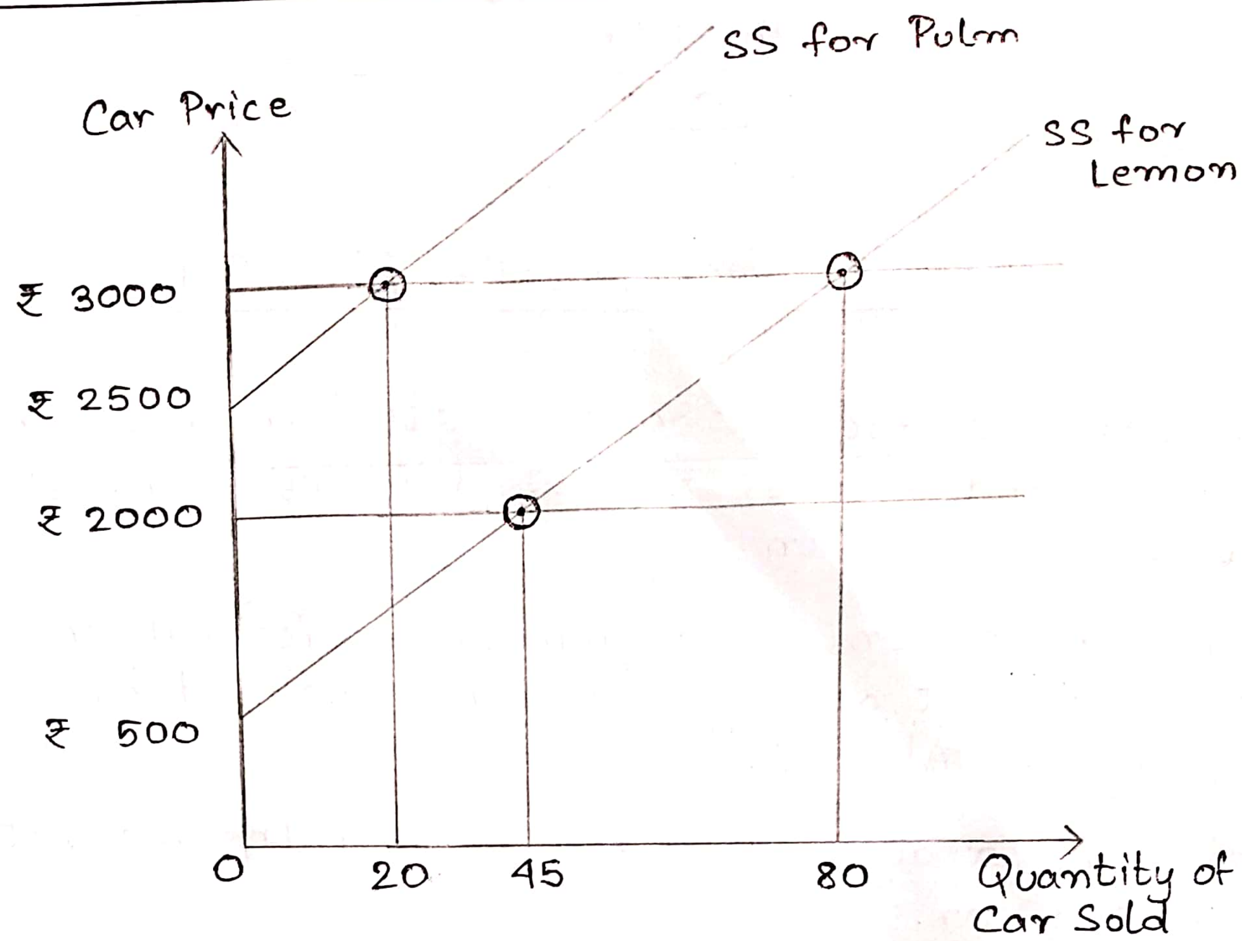
Akerlof's analysis goes far beyond the market for used car.

Suppose two kinds of used cars are available
- High quality cars (Pulm) and
  Low quality cars (Lemon).

In reality, the seller of a used car knows much more about it's quality than a buyer does.

Now, consider what happens, then, if sellers know the quality of cars, but buyers do not. This is explained with the help of the diagram given in the next page.

(P.T.O.)



In this diagram, in the vertical axis, we measure car price and in the horizontal axis we measure quantity of car sold.

Now, we discuss a situation when consumers willing to pay ₹2000 for Lemon and ₹4000 for Pulm.

But when the consumer think that there will be 50-50 chance of getting pulm or high quality of car. At that situation the consumer, suppose, pays ₹3000 for second hand car. At ₹ 3000, the consumer will get 20% pulm and 80% lemon. But consumer expected that he will get 50% pulm. That means asymmetric information give less pulm than his expectation.

(P.T.O.)

Now, we consider another situation when consumer is more pessimistic and they think that all cars are low quality, means Lemon.

Suppose at that situation consumer is willing to pay ₹2000. At this price, the supply of pulm is not available in the market, consumers will get only Lemon.

Therefore, we can see that with the presence of asymmetric information, the price of second hand car/used car decreases until the Lemons are sold out.

According to Akerlof, because of asymmetric information, low quality goods drive high quality goods out of the market. This phenomenon is sometimes refered to as the Lemon's problem.

With the presence of Asymmetric Information, market failure arise because there are owners of high quality cars who value their cars less than potential buyers of high quality cars. As a result both parties can enjoy gain from the trade. Unfortunately, buyer's lack of information prevents this mutually beneficial trade from occurring.

Reference -

1. Robert S. Pindyck & Daniel L. Rubinfield : - 'Microeconomics.', Prentice Hall.

2. Anindya Sen, Microeconomics : Theory and Application, OUP, 1999

(P.T.O)

Sample Questions -

1. Why can asymmetric information between buyers and sellers lead to market failure when a market is otherwise perfectly competitive ?

2. If the used car market is a 'Lemons' market, how would you expect the repair record of used cars that are sold to compare with the repair record of those not sold ?

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