

CREDIT AND THE ECONOMICS OF INFORMATION



Basic ideas

Example: the used-cars market

The theory of contracts



1-CREDIT AND THE ECONOMICS OF INFORMATION

- Contents
 - Some consequences of information asymmetry
 - How to transfer information and the resulting equilibria



1-CREDIT AND THE ECONOMICS OF INFORMATION

- Information asymmetry: when one party, involved in a transaction, has insufficient knowledge to make accurate decisions
- 2 kinds of asymmetric information: adverse selection and moral hazard
 - Adverse selection is an asymmetric information problem that occurs *before* the transaction takes place
 - Moral Hazard arises *after* the transaction occurs



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- Examples of adverse selection problems
 - You want to buy a used-car
 - Is it a good one or a bad one?
 - You want to choose a doctor (same question)
 - A firm wants to hire a worker
 - An insurance company is sollicitated to insure a young driver
 - A credit officer is sollicitated to lend to a new firm
 - Which master of finance would you choose? Lille2, ...



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- Examples of moral hazard problems
 - Once it has been credited, a firm can select a project riskier than expected ex ante by the credit officer
 - Once it has been insured, the young driver can behave less carefully than he would have if he was not insured

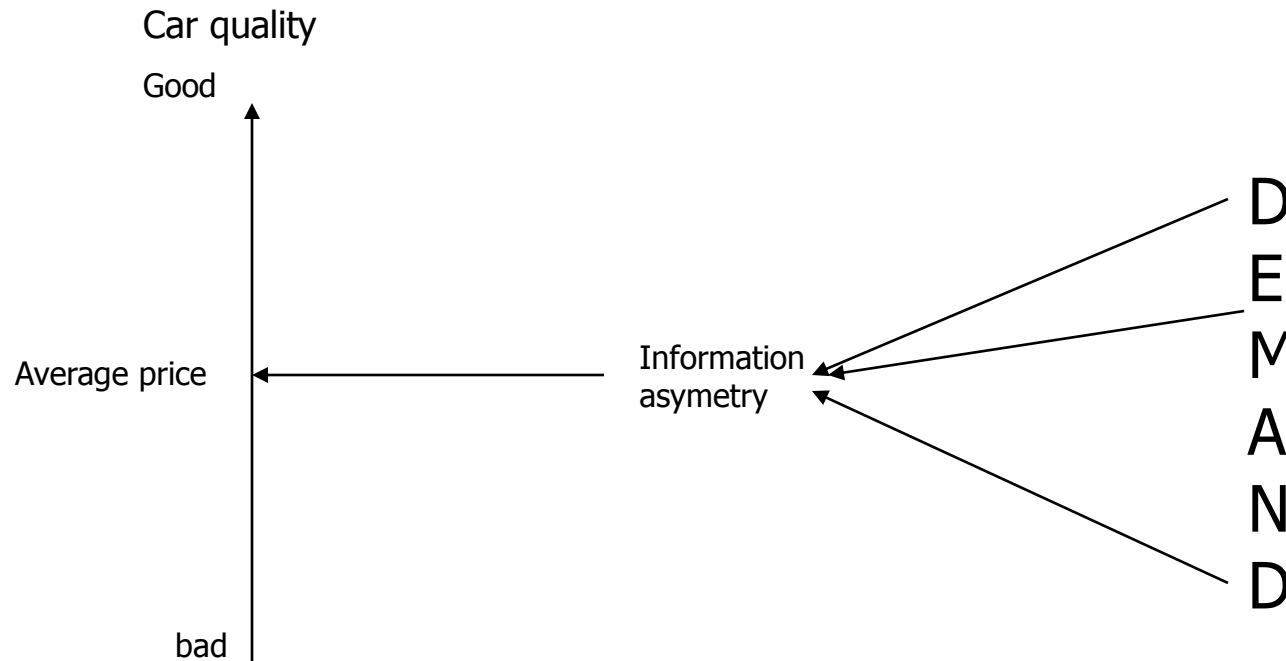


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- Some known consequences
 - Market failures
 - Price rigidity
 - Disequilibria

2-EXAMPLE: THE USED-CARS MARKET (Akerlof, 1970)

- Imagine the used car (Peugeot 307) market





2-EXAMPLE:THE USED-CARS MARKET (Akerlof, 1970)

- Consequences

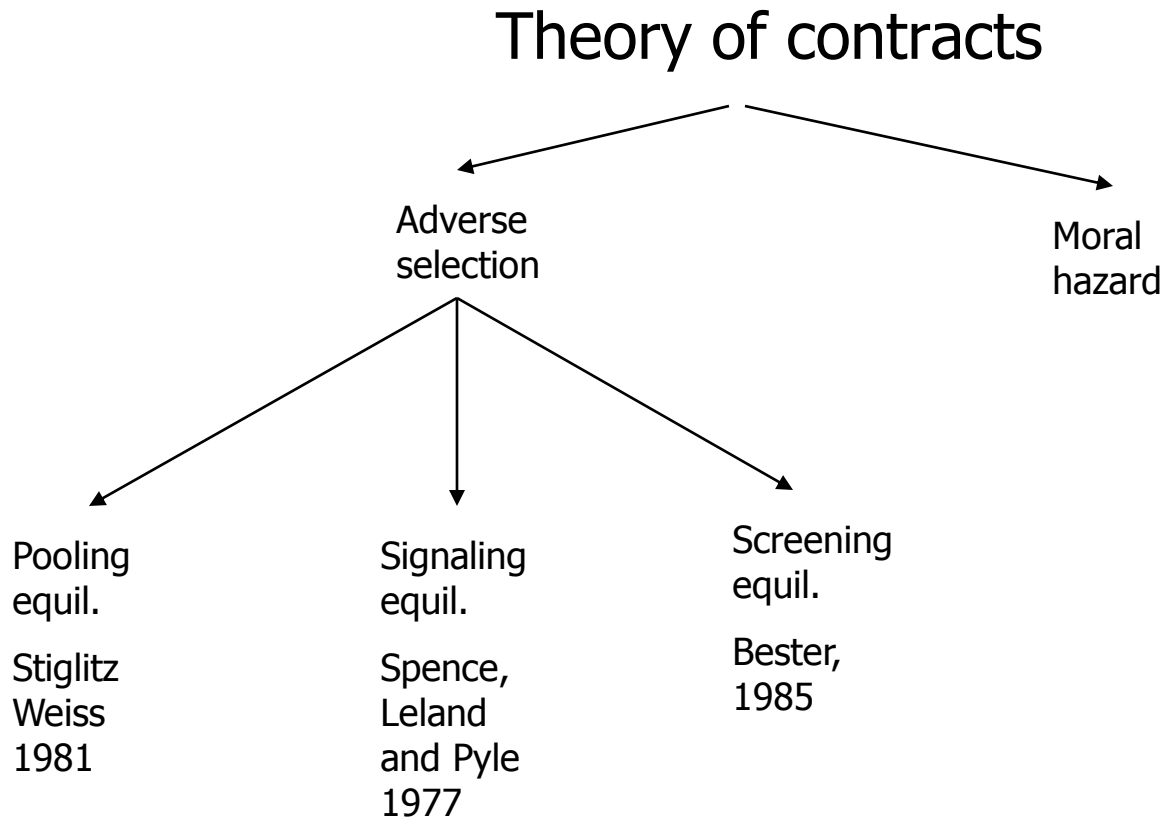
- If the car is a lemon, the owner is happy to sell it at the average price
- If the car is a peach, the owner knows that the car is undervalued
- As a result of this adverse selection, very few good cars will come to the market
- Because the average quality of a used car available in the market will be low, there will be few sales
- The used-car market will function poorly, if at all!



3-ASYMMETRIC INFORMATION AND THE THEORY OF CONTRACTS

- Tools to help solve the asymmetric information problem
 - Private production and sale of information
 - Signaling equilibrium
 - Screening by uninformed agents
 - Screening equilibrium
 - Regulation
 - Rating agencies
 - But when remains a residual information asymmetry, the resulting equilibrium is a:
 - Pooling equilibrium

3-ASYMMETRIC INFORMATION AND THE THEORY OF CONTRACTS





SUMMARY

- Information asymmetry is one of the most relevant hypothesis to explain financial behavior of agents and markets, structure of contracts and equilibria
- 2 types of information asymmetry: adverse selection and moral hazard
- There are several resulting equilibria



REFERENCES

- Akerlof, G. , 1970, The market for lemons: quality uncertainty and the market mechanisms, *Quarterly Journal of Economics*, 89, 488-500.