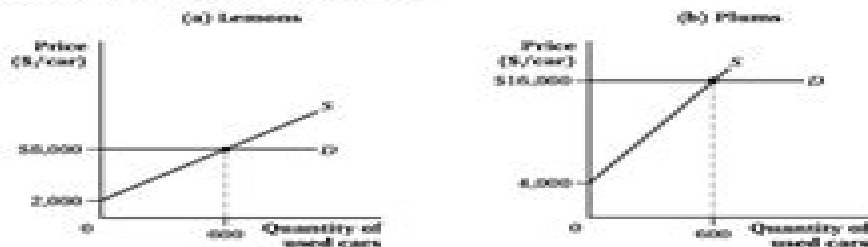


Asymmetric Information

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1. Consider the market for used cars shown in the figure below. The top panel (a) shows the market for low-quality cars (lemons); the bottom panel (b) shows the market for high-quality cars (plums). If all buyers and sellers had full information about the quality of automobiles being offered for sale, lemons would sell for \$8,000 and plums would sell for \$16,000.



- Suppose that buyers recognize that the chance of getting a lemon is 50%, but are unable to tell whether a car is a lemon or a plum. What is the expected value of a used car to a buyer?
- If the market works to the extent that prices reflect the expected value of a used car, how many high-quality automobiles will be offered for sale at the price determined in (a)? How many low-quality automobiles will be offered for sale? Of the automobiles offered for sale, what is the proportion of low-quality automobiles?
- Compared to a market with perfect information, what kind of deadweight loss does the information loss generate in the market for high-quality used cars? Is there a deadweight loss in the market for lemons, too?

Solutions

1. a. The expected value of a used car to a buyer is

$$(\$8,000 \times 0.5) + (\$16,000 \times 0.5) = \$12,000$$

- b. The supply of low-quality cars is given by $Q_L = \frac{1}{10}P_L - 200$.

The supply of high-quality cars is given by $Q_H = \frac{1}{20}P_H - 200$. Thus, given the expected value of \$12,000, there will be 400 high-quality cars and 1,000 low-quality cars offered for sale in the market. The proportion of low-quality cars to the total number of cars offered for sale is $\frac{5}{6}$.

- c. In a market with perfect information, there would be 600 low-quality cars sold at \$8,000. There would also be 600 high-quality cars sold at \$16,000. With asymmetric information, 1,000 low-quality cars and 400 high-quality cars are offered for sale at \$12,000. A deadweight loss exists in the high-quality used car market due to the lower number of high-quality cars sold, which is equal to

$$\frac{1}{2} \times (600 - 400) \times (16,000 - 12,000) = \$400,000$$

There may be a deadweight loss in the used car market as cars that should not have been sold at the real value of \$8,000 will sell at \$12,000. This would be equal to

$$\frac{1}{2} \times (600 - 400) \times (12,000 - 8,000) = \$400,000$$

2. In Problem 1, we discovered that imperfect information about the quality of used cars caused fewer plums and more lemons to be offered for sale. Thinking in discrete steps,

- How does this revision of the expected value affect the proportion of lemons to plums offered for sale by sellers?

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