ECO 301: Money and Banking
Instructor: Dr. James Murray
Writing Assignment: Financial Markets for "Lemons"

Learning Objectives:

- LO1: Understand and appreciate the importance of financial markets for the overall functioning of the economy.
- LO5: Analyze macroeconomic problems and prescribe appropriate monetary policy solutions.

George Akerlof first introduced the problem of adverse selection to economics. He demonstrated that when buyers and sellers are not equally informed on the quality of a good or service, inefficiencies can result that can lead to markets where only low quality products (the "lemons") are traded. In the most severe case, the market for a product or service may not exist altogether, even though in the presence of symmetric information there would be buyers and sellers who could agree to exchange at some price. Akerlof used the used car market as an example, but his paper describes how the adverse selection problem is evident in a wide array of market types. Read Akerlof's (1970) paper below. Also cited below is a short article that economist Tim Harford wrote for Slate that explains the adverse selection problem to a general audience. You may find it beneficial to read this article before jumping into Akerlof's paper.

We have seen in class how adverse selection also exists in financial markets for loanable funds. When lenders cannot distinguish high-quality borrowers (those most likely to repay the loan) from lesser-quality borrowers (those more likely to default on all or part of the loan), they set interest rates higher for both types to account for the risk, but at the cost of pricing the higher-quality borrowers out of the market. In the article below, Kirabeava (2010), demonstrates that adverse selection problems get worse as financial market conditions worsen, and the problem is further exacerbated with debt securitization and is a cause for systemic risk.

Summarize Kirabeava's argument and compare and contrast the asymmetric information problem present in financial markets with the examples and applications that Akerlof describes. What government policy does Kirabeava suggest to reduce the asymmetric information problem? What other measures could be taken or have been taken to reduce uncertainty asymmetric information in financial markets? Compare these actions with the "counteracting institutions" that Akerlof describes.

Your essay should be 4-6 pages, no more than double-space, and no more than 12pt font. You should cite the papers below and any additional papers that are appropriate to support your arguments.

Akerlof, G. (1970). Market for "Lemons": Quality uncertainty and the market mechanism, *The Quarterly Journal of Economics*, 84, 488-500.

Harford, T. (2006). If life gives you lemons... Why you can never buy a decent used car, *Slate* Posted online on April 29, 2006 at `http://www.slate.com/articles/arts/the_undercover_economist/2006/04/if_life_gives_you_lemons_.single.html`.

Kirabaeva, K. (2010). Adverse selection and financial crises, *Bank of Canada Review*, Winter 2010-2011, 11-19.