Webnote 2100. Market Failure Asymetric Information

Asymmetric information	Adverse selection	Moral hazard
What Is Asymmetric Information? Asymmetric information, also known as "information failure," occurs when one party to an economic transaction possesses greater material knowledge than the other party. This typically manifests when the seller of a good or service possesses greater knowledge than the buyer; however, the reverse dynamic is also possible. Almost all economic transactions involve information asymmetries. Source: investopedia	**What Is Adverse Selection?** Adverse selection refers generally to a situation in which sellers have information that buyers do not have, or vice versa, about some aspect of product quality. In other words, it is a case where asymmetric information is exploited. Asymmetric information, also called information failure, happens when one party to a transaction has greater material knowledge than the other party. Typically, the more knowledgeable party is the seller. Symmetric information is when both parties have equal knowledge. In the case of insurance, adverse selection is the tendency of those in dangerous jobs or high-risk lifestyles to purchase products like life insurance. In these cases, it is the buyer who actually has more knowledge (i.e., about their health). To fight adverse selection, insurance companies reduce exposure to large claims by limiting coverage or raising premiums. Source: investopedia	**What Is a Moral Hazard?** Moral hazard is the risk that a party has not entered into a contract in good faith or has provided misleading information about its assets, liabilities, or credit capacity. In addition, moral hazard also may mean a party has an incentive to take unusual risks in a desperate attempt to earn a profit before the contract settles. Moral hazards can be present anytime two parties come into agreement with one another. Each party in a contract may have the opportunity to gain from acting contrary to the principles laid out by the agreement. Anytime a party in an agreement does not have to suffer the potential consequences of a risk, the likelihood of a moral hazard increases. E.g Great Recession where the banks and financial institutions relied on a ‘too big to fail’ concept and were not accountable for their actions. As a result reckless lending and other practices caused major financial losses leading to the so called ‘great recession’. Source: investopedia