Waiting for News in the Dynamic Market for Lemons*

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Abstract

Trade breaks down in the market for lemons because high-type sellers have a reservation value greater than expected market value. Unraveling occurs and only the lowest types trade. Two related questions arise: What happens the next day? And, from where does the reservation value come? We model these considerations in a dynamic setting with gradual arrival of noisy information. We characterize the unique equilibrium in a continuous-time framework. The equilibrium involves a region of no trade or market failure. The no-trade region ends in one of two ways: either enough good news arrives restoring confidence and markets re-open or bad news arrives making buyers more pessimistic forcing market capitulation i.e., a sell-off of low value assets. Reservation values arise endogenously from the option to sell in the future. Our model also encompasses dynamic signaling environments. In a dynamic setting with sufficiently informative news, Spence’s Job Market Signaling and Akerlof’s Market for Lemons have the same unique equilibrium. The predictions help explain “irrational” trading patterns in financial markets.

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