

Waiting for News in the Dynamic Market for Lemons*

Brendan Daley[†]

Brett Green^{‡§}

February 2009

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.

*The authors are greatly indebted to Jeremy Bulow, Michael Harrison and Andrzej Skrzypacz for useful conversations, comments, and encouragement. Special thanks also to Peter DeMarzo, Ilan Kremer, Jon Levin, Paul Milgrom, Yuliy Sannikov, Bob Wilson and the seminar participants at Stanford, Duke and UNC for their useful comments and conversations.

[†]Fuqua School of Business, Duke University **Email:**bd2@duke.edu **Web:** <http://faculty.fuqua.duke.edu/~bd28>

[‡]Stanford GSB (Job Market Paper 2008-09) **Email:**greenb@stanford.edu **Web:** www.stanford.edu/~greenb

[§]Brett gratefully acknowledges the support of the SIEPR Dissertation Fellowship.