Unit 3
The Role of Information in an Economy

Transaction costs

- **Transaction costs are those costs associated with bringing buyers and sellers together.**

- Associated with making exchange possible

– Travel cost,
– Negotiation cost
– Property rights enforcement cost
– Cost of acquiring information

Information costs

- Information costs

– Costs of acquiring information on prices, product qualities, and product performance

- Costs of telephone,
- Inspecting goods,
- Monitoring the honesty customers,

- Reading ads and consumer reports
- Shopping for more information

- Internet has, of course, reduced information costs

- By allowing people to be paid for their scarce information, the price system economizes on information costs

Transaction cost and Economic Costs

- Transaction costs are affected by information costs

- Knowledge of the existence and location of a willing buyer is valuable information to the seller
  - Information cost has to be incurred by the seller to actually locate and find out a willing buyer

- Without this information, economic transaction performed by the buyer and seller cannot take place

The economy of search

- Consumer incurs search costs while shopping, reading, or consulting experts in order to acquire pricing or quality information

- To gather all the available information would take an inordinate amount of time and money

- Benefit from acquiring more information has to be compared with Cost of acquiring more information

Information problems

- Moral hazard problem
- Adverse selection

Moral-hazard problem

- Exists when one of the parties to a contract has an incentive to alter his or her behavior after the contract is made at the expense of the second party.

- It arises because it is too costly for the second party to obtain information about the first party's post contractual behavior.

Moral hazard - Example

- Scheme on buying a new Car
  - Free servicing and warranty on a car for first four years
  - Hazard: Longer drives and rough drives in these first four years
  - Solution:
- Free servicing and warranty on a car “for first four years” or “upto 50000 KM” whichever occurs first

Adverse-Selection Problem

- Occurs when one party to contract engages in opportunistic behavior after the contract is made
- Buyer or seller enters a disadvantageous contract on the basis of incomplete or inaccurate information
- Cost of obtaining the relevant information makes it difficult to determine whether the deal is a good one or bad one

Adverse-Selection Problem

- Example
  - A good driver and a rough driver entering into an exactly the same insurance contract
  - Insurance company doesn’t know beforehand who is a bad and who is a good driver
  - The bad driver has relative advantage on the contract

Speculation

- Speculators are those who buy or sell in the hope of profiting from market fluctuations

- Buy or sell commodities in huge quantities in huge quantities hoping to profit from a frost, war, scare, bad news, or good news

- Mantra
  - buying low and selling high, which results in profit

- Information about probable changes in the market conditions plays a vital role

- **Arbitrage**
  - Buying in a market where a commodity is cheap and Reselling in a market where the commodity is more expensive
  - **Information** about market places and their varying prices becomes a value in arbitrage
- Speculators work with different time period while arbitrage is concerned with different market places

- **Profitable Speculation**
  - Speculation that succeeds in buying low and selling high
  - Necessary to correctly anticipate that next periods market conditions
  - Shifts supplies from “*periods when supplies are relatively abundant*” to “*periods when supplies are relatively scarce and prices potentially high*”
- **Unprofitable Speculation**
  - Buy thinking that price is low
    - But it gets lower than what they think is the lowest
  - Sell thinking that price is at the highest level

    - But price gets even higher in the market
  - While buying and selling for speculative purpose, they are spending somewhat more and gaining somewhat less than what could have achieved

- Happens due to incorrect guessing by speculators

The Futures Market

- Organized market in which a buyers and sellers agree now on the price of a commodity to be delivered at some specified date in the future.

- **Spot (cash) market**
  - Arrangement between buyers and sellers are made now for payment and delivery of the product now
- **Future contracts**
  - The terms (the price and the quantity) of a futures transaction are set today

- Delivery and payment are to be made in the future
- Delivery of specified quantity of the good at the specified price at the specified future date

Information and Speculation in the futures market

- Speculation done for the future

- Speculation is based on information
  - Leads to anticipation of some price hikes and probability to earn some profit

- Future is Uncertain anyways
  - So, information is not fully reliable

- Decisions have to be taken on the present