

Reversing famous results in signalling, adverse selection and search

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In one-shot pure Spence signalling, a higher-cost sender always exerts less effort. Making signalling dynamic, a higher-cost sender exerts more effort in some equilibria to avoid future information revelation. The interpretation of a given signal switches endogenously over time, depending on which type is expected to send it.

Under adverse selection, greater gains from trade increase trade and payoffs. However, if accessing a lemons market is costly and stochastic (requires lobbying, search or R&D), then greater gains from trade or a smaller entry cost may reduce entry, trade and payoffs, due to a novel feedback between the market composition and the investment in access.

If switching firms is costly for consumers, then firms set the monopoly price (Diamond 1971). Making firms privately informed about their (negatively correlated) quality and cost restores competitive pricing. Quality decreases in cost due to e.g. regulation, economies of scale, differing equipment or skill. If good-quality firms have lower costs, then they signal quality by cutting prices. Bad-quality firms must then cut prices to retain customers. This alternating price-cutting ends when bad-quality firms charge their competitive price and good-quality firms slightly less.