3.3 Asymmetric information and market power

Name: _____ Class: _____ Date: _____ **Total: 16 marks**

KEY WORDS asymmetric information • adverse selection • moral hazard • barriers to entry • oligopoly • concentration ratio

Objective

Build the skills to answer exam questions on **asymmetric information** (adverse selection and moral hazard), **market power** , the four market structures, and government responses.

You must be able to:

- distinguish adverse selection from moral hazard, with examples
- evaluate signalling, screening and regulation as responses to asymmetric information
- compare the characteristics of perfect competition, monopolistic competition, oligopoly and monopoly
- explain why market power can lead to allocative inefficiency, and evaluate government responses

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1 Key knowledge and worked examples

Asymmetric information and market power

Asymmetric information: one party to a transaction has more or better information than the other, so the market may fail.

problem	when it happens	example	responses
adverse selection	**before** the deal: the better-informed side gains	sellers of used cars know their faults; high-risk people buy more health insurance	**signalling** (warranties, qualifications), **screening** (medical checks, credit checks), regulation, licensing
moral hazard	**after** the deal: one side changes behaviour because it does not bear the full cost	insured drivers take more risks; banks take risks expecting a government rescue	excess payments (deductibles), monitoring, regulation of banks

Market structures:

	perfect competition	monopolistic competition	oligopoly	monopoly
number of firms	very many	many	a few large	one
product	identical	differentiated	identical or differentiated	unique, no close substitutes
barriers to entry	none	low	high	very high
price-setting	price taker	some power	interdependent	price maker

Barriers to entry: economies of scale, legal barriers (patents, licences), control of resources, brand loyalty, high start-up costs, aggressive pricing.

Market power lets a firm restrict output and charge a higher price than in competition, so **MSB > MSC** at its output: allocative inefficiency and a **welfare loss**. A **natural monopoly** exists when one firm can supply the whole market at lower average cost than two or more (water, rail networks).

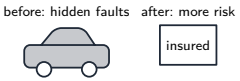
Government responses: competition (anti-monopoly) **legislation**, blocking mergers, fines for **collusion** (cartels), price regulation of natural monopolies, nationaliza-

tion, opening markets to trade.

Answer shapes: identify the problem → explain with an example → evaluate a response (cost, effectiveness, side effects).

2 Practice

2.1 Distinguish between adverse selection and moral hazard. [2]



2.2 Outline **two** barriers to entry in the market for passenger aircraft. [2]



2.3 Explain **two** ways in which buyers and sellers of used cars can reduce the problem of asymmetric information. [4]

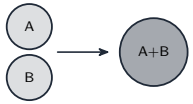


3 Exam-style questions

3.1 Two mobile phone networks control most of a country's market and plan to merge.

(a) Identify **one** feature of an oligopoly in this case. [2]

(b) Evaluate a government decision to block the merger. [6]



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Solutions

Marking: **M1** a correct method, **A1** the correct answer, **B1** an independent mark.

Each answer shows the steps, then the **result**.

2.1

adverse selection happens before a transaction, when one side uses hidden information, e.g. a seller hides faults; moral hazard happens after an agreement, when one side takes more risks because it does not bear the full cost, e.g. an insured driver drives carelessly

2.2

any two: huge start-up / research costs; economies of scale of existing firms; patents and technical expertise; safety certification rules; long-standing customer relationships and brand reputation

2.3

signalling: the seller offers a warranty / full service history to show the car is good; screening: the buyer pays for an independent inspection / checks the car's history online; government: laws requiring honest descriptions, licensed dealers

3.1

(a) a few large firms dominate the market / high barriers to entry (licences, networks) / interdependence

(b) a merged firm would have near-monopoly power; it could raise prices and cut output, giving allocative inefficiency and a welfare loss for consumers; less incentive to improve quality or innovate; but a larger firm may gain economies of scale, lowering average costs; and may have more funds for investment, e.g. 5G networks; judgement: block, or allow with conditions such as price caps or selling some assets

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