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ACCEPTED MANUSCRIPT

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Abstract

In view of some recent empirical evidence, I suggest a relationship between the magnitude of search costs and the severity of adverse selection in the context of a dynamic model with asymmetric information. In markets with small search costs sellers with low quality products misrepresent their quality and demand a high price. If search costs are not negligible, sellers' price offers are truthful and all product qualities are traded over time. In markets with small search costs, a budget balanced mechanism can mitigate adverse selection: sellers should pay a per period market participation tax and receive a rebate after trading.

JEL classification: D47, D82, D83.
Keywords: Dynamic Adverse Selection, Decentralized Markets, Search Theory, Time on Market Observability.

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1. Introduction

Information asymmetry is a pervasive feature of real world markets: financial securities, real estate, electronics and secondhand vehicles are just a few examples. In these markets one side—usually buyers—may lack the information or experience to ascertain the true quality of a specific good. Since Akerlof's (1970) seminal article, it is a well known result that high quality goods may not be traded if buyers believe there is a high chance of buying a 'lemon.' Clearly, real world markets present a much more complex environment than the static adverse selection model, and a growing literature has been reconsidering the effects of asymmetric information in a dynamic setting.

The theoretical literature offers contrasting views. On the one hand, Janssen and Roy (2002), Blouin (2003), Camargo and Lester (2014), Fuchs and Skrzypacz (2015) and Moreno and Wooders (2016) claim that sellers signal a higher product quality by delaying trade. In these models, low

[☆]A draft of this article has previously been circulated under the title 'Is Time Enough to Alleviate Adverse Selection?'. The views expressed in this article are those of the author and are not the responsibility of the Bank of Italy. All errors remain mine.

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