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On Signalling and Screening in Markets with Asymmetric Information

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Abstract

This paper studies stylised markets with asymmetric information. When the market is modelled as a standard signalling game, inefficient outcomes arise due to the arbitrariness of off-the-equilibrium path beliefs. Such inefficient outcomes are shown not to arise in a novel game that combines signalling and competitive screening. In this game, the informed party makes an initial offer to all uninformed parties, but the uninformed parties are allowed to make counter-offers after accepting the initial offer. The initial offer serves as a barrier to potential cream-skimming deviations, and hence, equilibrium is shown to generically exist. As such, the paper also contributes to the literature that focuses on laying strategic foundations for efficient competition in competitive screening markets.

KEYWORDS: Signalling, competitive screening, asymmetric information, existence, efficiency

JEL CLASSIFICATION: D82, D86

1 Introduction

Since the seminal contribution of Spence (1973), signalling models have been highly successful applied to explaining a variety of economic phenomena such as capital structure

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