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Adverse Selection in Asset Markets: Theory and Evidence from the Indian Market for Cows

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Abstract

Dairy cows cycle through periods where their quality is more observable (the milking phase), and where their quality is less observable (the dry phase). This variation in quality observability creates the potential for an adverse selection problem. I develop a theoretical model of trade in dry and milking cows and find empirical evidence consistent with the adverse selection theory. In particular, dry animal prices fall less in response to negative shocks relative to milking animal prices, which is consistent with the model's prediction that negative shocks actually help the dry animal market by pushing more high quality owners to sell.

Keywords: Adverse Selection, Agricultural Markets, Livestock, India

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