Microeconomics, Module 10: “Knowledge and Information” (Chapter 9)

Key Concepts

(The attached PDF file has better formatting.)

Chapter 9 of Landsburg’s text discusses three topics; Module 10 covers the third one.

- Comparison of the free market price system with central planning.
- Efficient markets like those for financial assets, in which prices fully reflect all available information (covered in the corporate finance course).
- Markets that are not Pareto optimal because information is asymmetrically distributed.

Section 9.1 compares prices in free markets with the central planning characteristic of socialist economies. Prices in competitive markets put together the knowledge of economic actors, convey this information to consumers and firms, and provide incentives for them to maximize social welfare. A central planner without this knowledge can not achieve the gains from a competitive market system.

At some American, British, and continental European universities, where socialist ideology is still strong, an economist like Landsburg must defend the price system of free markets. But this is common knowledge among actuarial candidates, so the on-line course skips this section. If you want to know why most Communist economies have collapsed whereas free market systems are strong, this section provides part of the answer.

Question: Does anyone still doubt that free markets are better than central planning?

Answer: The European Union restricts free markets and over-regulates economic activity. Labor markets are not free in many Western European nations: firms have difficulty hiring and firing employees, unemployment rises, and economic activity suffers. We do not say that U.S. “employment at will” (the right to hire and fire without cause) is more equitable or more fair; these are normative issues that people disagree on. But employment at will causes less unemployment and more efficient economies in the long-run.

Section 9.2: Prices in *efficient markets* fully reflect all available information. The U.S. stock market is perhaps the most efficient market in the world, implying that technical analysts are wasting their time and individual investors who buy and sell stocks in hopes of making high profits are burning cash as they pay commissions to brokers. The Brealey and Myers text in the corporate finance course covers this subject at length, so we skip this section in the Landsburg textbook.

Question: Brealey and Myers has three forms of the efficient market hypothesis: weak, semi-strong, and strong. Which version is Landsburg using?

Answer: Landsburg uses the semi-strong form; markets incorporate all available information into the current price.

Section 9.3: If information is not distributed symmetrically, the market outcome may not be optimal. Landsburg has four examples of informational asymmetry relevant to actuaries.

- *Signaling*, which plays an important role in actuarial education
- *Adverse selection*, which affects individual health and life insurance (and other lines)
- *Morale hazard*, which is a serious problem in personal auto and Homeowners
- *Principal agent problems*, which may help explain why so many life insurers were mutual companies in the early 20th century and why so many of these insurers demutualized in second half of the 20th century.

Section 9.3 is covered in this course; read it well. Candidates taking the CAS transition exam should read sections 9.1 and 9.2 as well.