Introduction to the Article:
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Economic Impact of Asymmetric Information Theory in Financial and Capital Markets - Anoop Sagdeo

Introduction:

The attempt is made in the first article of this series trying to explore the impact of economics of asymmetric information on the decision making process in the two sectors vital to the macro-economics. They are the financial sector market and the capital sector market of the economy. Each article will address the content issues of the asymmetric theory and the practical application thereof on the particular aspect of these two markets.

In the beginning, while reviewing the existing literature on this theory, on the electronic and print media; authors have taken references of the articles written by international scholars from different websites and the views expressed by the Indian scholars through paper presentation in one of the national level conference, which are further edited in the book form by Economics of Asymmetric Information by Nachane and Chatterjee, (2006). There are endless references as the topic is widely accepted by the theoreticians and the practitioners.

The dictionary meaning of the term is a ‘condition in which at least some information is known to some but not to all the parties to the transaction’.

According to economists, ‘information asymmetry causes market to become inefficient; since all the market participants do not have access to the information they need for their decision making process’. 
One can begin his study by referring to the outstanding work by the Nobel Prize winning trinity-Akerlof, Spence & Stiglitz (2001), who demonstrated that market may break down completely in the presence of asymmetric information and the three distinct consequences emerging,

(a) Adverse selection,
(b) Moral hazard, &
(c) Monitoring cost

All the economists, even classical like Smith, Mill and Marshall, seem to have included this information related problem in their work. The concept of famous invisible hand by Smith, (1776), speaks about the intervention of state in the competitive market, the Pareto's welfare economics based on the competitive or efficient allocation relying upon the uniformly distributed information amongst the economic agents. Of course, one does not till recently, find appreciation of the fact that the informational inadequacies could change the very nature of competitive equilibrium. But it is in the beginning of 1960s, the scrutiny of market theories and general equilibrium model was started in the shadow of macro-economic implications of deficiency of information on the market theories.

The culmination of this economic scrutiny is comprehensively presented in the interpretative essay of Akerlof's on the "The Market for 'Lemons".

Application of Asymmetric Information:

This section deals with the empirical evaluation of the concept as a potential issue in the field of equity market, especially how and when the overvaluation and the undervaluation is done by the firms during their stock and the debt issue. It also deals with the influence of asymmetric information prevailing in the credit market and it's implication on corporate financial management.

Impact on the Financial Market:
Three results of the Asymmetric Information syndrome on the financial or more precisely the credit market are best reflected in the sourcing of external funds by the corporate. The transaction between the borrowers offers the best example/s to study their practical implications.

Every firm has to inevitable take recourse to the external source of financing while preparing the mix of owners fund and the borrowed funds. The borrowed funds come with some conditions, to be complied by parties to these transactions. Both the parties to this financial transaction have to have exchange the relevant information between each other. Do, both the parties pass on the symmetric information is a moot question. It is proved by several examples in the domestic and the global finance symmetric information is theoretical and whereas the asymmetric information is a reality.

The focus of the study is to find out the net results in the form of adverse selection, moral hazards & the monitoring cost. Let us analyze them one by one.

The borrowers voluntarily or per force take recourse to concealing of the information for making their case as a strong candidature for obtaining the external finance. In this, the efforts are done to hide uncomfortable economic information on the real risk involved in the project. It, therefore, reduces the ability of the lending institution to foresee the hazards inherent to the project. The feasibility and the viability of the proposed project are miscalculated due to the imperfect information received from the borrower. The imperfect decision made on the on the basis of imperfect information has a cascading effect on the financial market legitimately resulting in economic crisis. How many examples one needs to prove this fact, when we have ample cases at national and the global level both.

The starting point of this economic downturn due to financial mess occurring on account of this less than perfect decision is the shifting of the priority in the utilization of the borrowed funds. The basic purpose of the borrowing funds remains hungry or gets starved for the adequate funds in order to get the predetermined rate of return on investment. This further increases the cost of the external finance and retention of owners’ earnings. At times this forces crossing of the safe limits of project viability. Subsequently, there is an unwarranted rise in the costing due to ever increasing cost component i.e. compounding of interest. The vicious cycle of diminishing the value of assets is sets in; further leading to the non-performing assets on one hand and the mounting bad debts on the other. It sets in the dead burden of bad financing at micro and macro levels. The problem gets compounded due to the monitoring cost involved in the salvaging the
emerging financial crisis trading the path of downturn.

The situation is not different in the case of the capital market too. The transactions at a stock market provide the classic example of Asymmetric information and the effects thereof. The beneficiaries, the underwriters and the project owners, parties to the transactions, wisely use this practice of imperfect information to their advantage at the time of stock-issue or while raising debts, through the chosen issuance of stocks or bonds. This offers good example to prove the proposition of signaling (Michael Spence) and the screening mechanism (Joseph Stiglitz).

**Impact on the Capital Market:**

Equity market works on the forward looking statements and published financial and other data made available by the company as public information. This forms the base information on which price of equity is determined. There are several tools available in public domain to accurately calculate the price of equity under the given scenario. In an ideal case of perfect symmetric information being available to all the parties in the market using the same tools, everybody will come at the same price for the equity. Assuming a rational investor expecting rational returns and evaluating the equity as an independent asset class, when everybody is at the same price for the equity, there isn’t a sufficient incentive for transaction of equity. However, in practicality there is never perfect symmetric information available about the equity. Parties with some additional information about the equity (which is concealed from others) will come up with a new estimate for price of equity, and hence there will be a trade of equity. Equity market functionality is thus based on assumption that there is asymmetric information in market and hence every investor will have different views about price of equity. This is normal and expected behaviour because the parameters and variables defining the price of equity are huge and it is difficult for each individual to have same amount of perfect symmetric information.

This gets ratified when we compare the rate of returns in developed and evolving markets. Daily fluctuations in equity prices in developed markets hardly cross 1% mark as the statutory requirements in these markets are stringent and also strictly enforced, reducing the information asymmetry to large extent. However in developing markets; because of the inbuilt flux of a developing economy information asymmetry is higher; and hence the getting a daily return of over 5% if very normal in these markets. So often or not do we get to hear the case of insider trading resulting into abnormal returns. This is a classical case of adverse selection resulting out of asymmetric information in equity markets.
All the three economists through their warnings offer some clues to salvage the uncomfortable economic situation. Therefore, we at arthaar.com invite the debate on this issue by presenting the case studies by the academicians and the professionals working in these volatile sectors of the economy.