Intermediating Adverse Selection ¹

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Intermediating Adverse Selection

We propose a parsimonious model of over-the-counter trading under asymmetric information to study the presence of intermediary chains that stand between well informed parties and uninformed market participants. Multiple moderately informed intermediaries can fulfill an important economic role of “smoothing” adverse selection. Informed market participants may prefer to trade through these intermediary chains as they improve trade efficiency but also reduce the surplus accruing to uninformed traders. Our model makes novel predictions about optimal network formation when adverse selection problems impede the efficiency of trade.

Keywords: Intermediation, Trading Networks, Adverse Selection, Asymmetric Information

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