**Intro to *Inside Job* – Imperfect Information as a** [**Market**](http://welkerswikinomics.com/blog/glossary/market/) **Failure:**

Imagine this. You’re in the [market](http://welkerswikinomics.com/blog/glossary/market/) for a used car. You go to the used car dealership, speak with a salesman, and he takes you through rows of automobiles, telling you the features of each one and assuring you that each of his cars has been inspected by a third party garage for reliability. You find this re-assuring; after all you wouldn’t want to buy a car that hasn’t passed a basic inspection, since you don’t want it to break down once you’ve driven it off the lot.

After an hour or so of poking around the lot, you pick out the perfect car. A silver 2006 Audi, a great year for Audis, says the dealer. You have his word that it has been closely inspected and is in top notch shape. So you hand over $20,000 for the Audi and drive it off the lot, satisfied with your purchase.

What would you say, however, if you knew that soon after driving off the lot, the very salesman who convinced you to buy that Audi purchased an insurance policy that would pay the salesman $20,000 in the case that it broke down. Would that knowledge have made you question your purchase?

What would you say if you found out that the “third party garage” the salesman used to inspect the car actually followed orders from the dealer himself, and was 100% dependent on that dealer’s business. Therefore, the mechanic was under significant pressure to give each of the cars sent to him a high mark in its inspection. By doing so, the garage mechanic assures that the dealer is able to easily sell cars to the buyers who trust that the mechanic has given an honest appraisal of the car’s mechanical reliability. Since the dealer can sell cars given high inspection marks for higher [prices](http://welkerswikinomics.com/blog/glossary/price/), the dealer is then able take out insurance policies that pay a greater amount when the car ultimately breaks down.

Would all of this knowledge have made you questions your purchase and the [price](http://welkerswikinomics.com/blog/glossary/price/) you paid for your Audi? Chances are, if there had been **perfect information** in the [market](http://welkerswikinomics.com/blog/glossary/market/) for used cars, you, and countless other people, would not have been willing to pay the [price](http://welkerswikinomics.com/blog/glossary/price/) you paid for your Audi. Fewer used cars would have been sold, and they would have sold for lower [prices](http://welkerswikinomics.com/blog/glossary/price/). The existence of asymmetric information results in an over-allocation of resources towards the [market](http://welkerswikinomics.com/blog/glossary/market/) for mechanically unsound used cars.

So what does the story above have to do with the global financial crisis? Believe it or not, the fundamental cause of the near collapse of the global financial system in recent years is almost identical to our story about the used-car salesman, the corrupt garage mechanic, the dubious insurance policies and the sucker buyer, who was stuck driving a crappy car that broke down within days of driving it off the lot.