

Communication, Feedback and Repeated Moral Hazard with Short-lived Buyers

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Abstract :

We show that experience good sellers facing myopic buyers can solve the inherent moral hazard problem by communicating their observation of quality before trade, provided that communication is part of their public track record. Such cheap-talk communication, if trusted, allows market prices to reflect the actual value created, thus providing an immediate reward for the seller's effort which complements the conventional, reputational incentives. We characterize the conditions for communication to improve efficiency—which requires the moral hazard problem to be acute enough and the seller's information to be precise enough—and the extent to which it does so.