

## **Illustration 12.1**

### **Perfect Competition in Financial Markets**

Of all the markets we are familiar with, none more closely fits the definition of perfect competition than financial markets—stock markets, markets for foreign exchange, bond markets, and so on. Consider each of the characteristics of a perfectly competitive market:

#### **Homogeneous product**

The assets traded on financial markets are as homogeneous as products can be. A share of GM stock sold by one brokerage house is identical to a share sold by another.

#### **Individual traders small relative to the market**

While one trader may hold a large percentage of the shares of a particular firm, the holdings of any individual trader relative to the total market are still small.

#### **Unrestricted entry and exit**

In financial markets, entry occurs on the demand side. (The supply of GM stock is effectively fixed, and it is the demand for GM stock that determines its price.) And there are no barriers to entry. It is an easy matter to enter the market and buy or sell financial assets. Indeed, in financial markets, you can even sell securities you don't own—sell short—if you believe the price is too high.

In addition to these characteristics, the financial markets have special features that make them more than simply competitive:

#### **A centralized marketplace**

While the traders need not travel any further than the computers on their desk tops, there is one central marketplace, rather than several smaller markets. Hence, every buyer has access to every seller, and vice versa.

#### **Widespread information**

There are well-established institutions for collecting and distributing information; for example, *The Wall Street Journal*, the S&P Manuals, Moody's Bond Rating Service, Value Line, and the Dow Jones Broad Tape. Indeed, these markets come about as close to perfect knowledge as markets are going to get.

#### **No constraints on rapid price adjustment**

If the market participants in the financial markets determine that the price is too high, it will change immediately. There are no long-term contracts that tend to constrain the adjustment of price.