Product Market Competition and Stock Market Efficiency

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Abstract

How does competition in a firm's product market affect the behavior of its stock? We examine this question in a noisy rational expectations economy in which firms operate under monopolistic competition. Production is subject to productivity shocks and requires capital, raised on a perfectly competitive equity market. Investors observe firms' past profits and collect private information about their productivity which is partially reflected in stock prices. Firms use their monopoly power to insulate profits from shocks. This influences the collection of private information about more competitive firms in two conflicting ways. On one hand, their current profits are riskier, but on the other, their past profits are more informative about their productivity. We describe the level of private information in equilibrium, the dispersion of investors' forecasts, the informativeness of stock prices, the volatility of profits and returns and the efficiency of the capital allocation. In particular, we show that the interaction of monopoly power in the product market with information asymmetries in the equity market has a social impact which adds to the usual cost of imperfect competition.

Keywords: Product market competition, efficiency, asymmetric information, information acquisition

JEL classification codes : G11, G12, G14