The Arbitrage Principle in Financial Economics

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Abstract

The importance of arbitrage conditions in financial economics has been recognized since Modigliani and Miller's classic work on the financial structure of the firm. They showed that if a firm could change its market value by purely financial operations such as adjusting its debt-equity ratio, then individual shareholders and bondholders could engage in analogous portfolio transactions that would yield pure arbitrage profits. If the market was efficient enough to eliminate arbitrage profits for the individual shareholders, then it would eliminate arbitrage profits for the firm as well. Subsequently, financial economists have used arbitrage arguments to examine a variety of other issues involving asset pricing. One of the major advances in financial economics in the past two decades has been to clarify and formalize the exact meaning of "no arbitrage" and to apply this idea systematically to uncover hidden relationships in asset prices. Many important results of financial economics are based squarely on the hypothesis of no arbitrage, and it serves as one of the most basic unifying principles of the study of financial markets. In this essay we will examine some of these results.

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