

TOPIC 6:
Market Structure

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Market Structure

- Market structure – identifies how a market is made up in terms of:
 - The number of firms in the industry
 - The nature of the product produced
 - The degree of monopoly power each firm has
 - The degree to which the firm can influence price
 - Profit levels
 - Firms' behaviour – pricing strategies, non-price competition, output levels
 - The extent of barriers to entry
 - The impact on efficiency

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Market Structure

Perfect Competition

Pure Monopoly

More competitive (fewer imperfections)

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Market Structure

Perfect Competition

Pure Monopoly

Less competitive (greater degree of imperfection)

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Market Structure

Perfect Competition Pure Monopoly

The further right on the scale, the greater the degree of monopoly power exercised by the firm.

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Market Structure

- Importance:
- Degree of competition affects the consumer – will it benefit the consumer or not?
- Impacts on the performance and behaviour of the company/companies involved

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Market Structure

- **Models – a word of warning!**
 - Market structure deals with a number of economic 'models'
 - These models are a representation of reality to help us to understand what may be happening in real life
 - There are extremes to the model that are unlikely to occur in reality
 - They still have value as they enable us to draw comparisons and contrasts with what is observed in reality
 - Models help therefore in analysing and evaluating – they offer a benchmark

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Market Structure


- **Characteristics of each model!**
 - Number and size of firms that make up the industry
 - Control over price or output
 - Freedom of entry and exit from the industry
 - Nature of the product – degree of homogeneity (similarity) of the products in the industry (extent to which products can be regarded as substitutes for each other)
 - Diagrammatic representation – the shape of the demand curve, etc.

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Market Structure

Characteristics: Look at these everyday products – what type of market structure are the producers of these products operating in?



Remember to think about the nature of the product, entry and exit, behaviour of the firms, number and size of the firms in the industry.

You might even have to ask what the industry is??

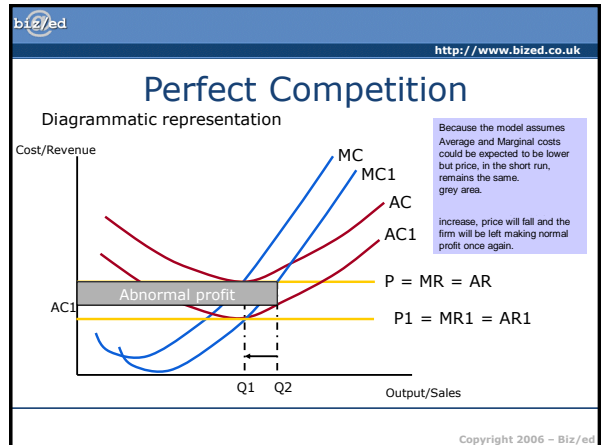
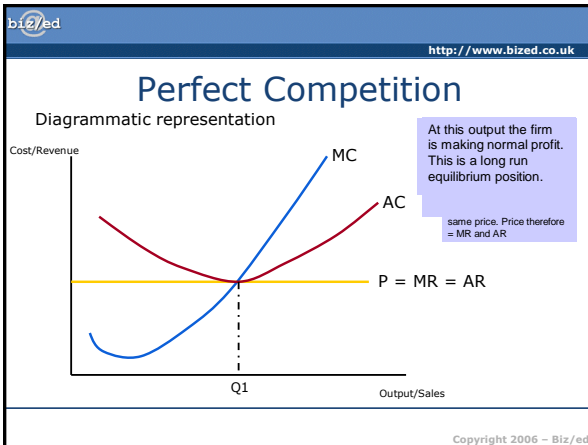
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Perfect Competition

- One extreme of the market structure spectrum
- **Characteristics:**
 - Large number of firms
 - Products are homogenous (identical) – consumer has no reason to express a preference for any firm
 - Freedom of entry and exit into and out of the industry
 - Firms are price takers – have no control over the price they charge for their product
 - Each producer supplies a very small proportion of total industry output
 - Consumers and producers have perfect knowledge about the market

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Monopolistic or Imperfect Competition

- Where the conditions of perfect competition do not hold, 'imperfect competition' will exist
- Varying degrees of imperfection give rise to varying market structures
- Monopolistic competition is one of these – **not** to be confused with monopoly!

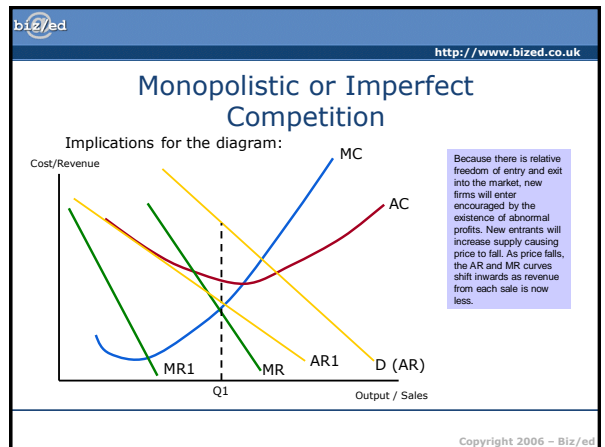
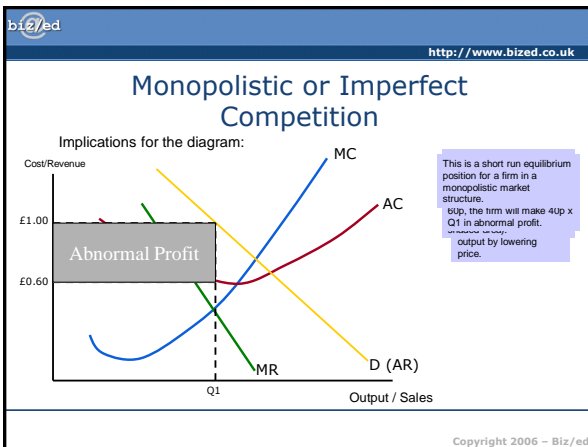
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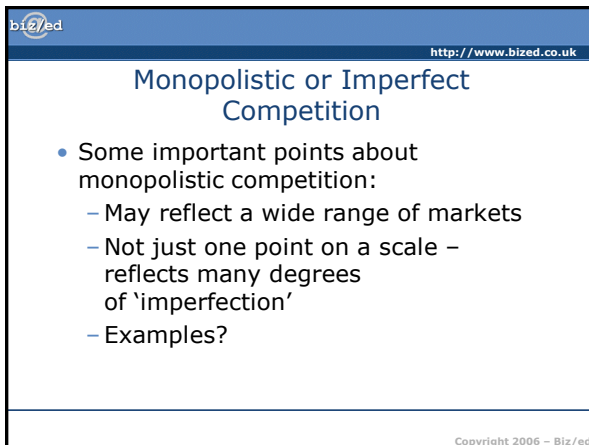
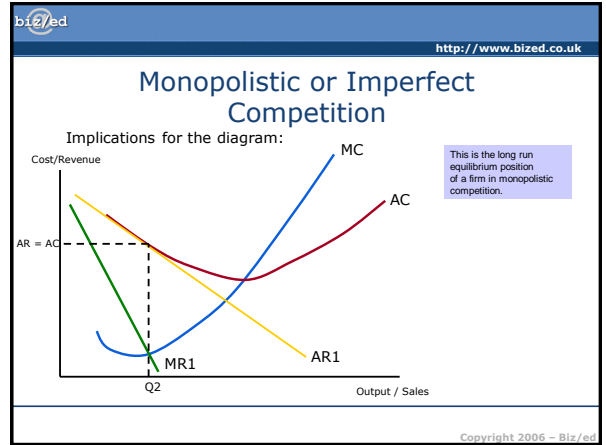
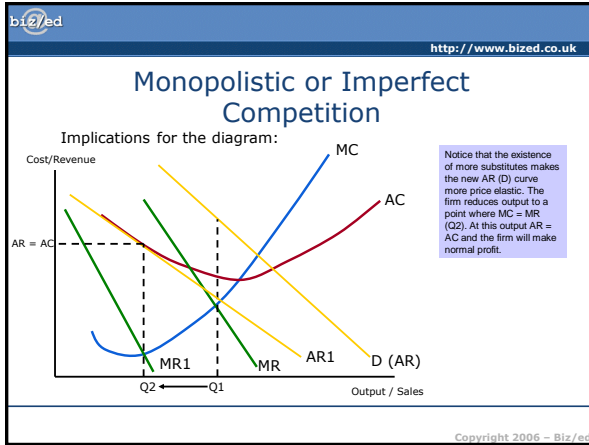
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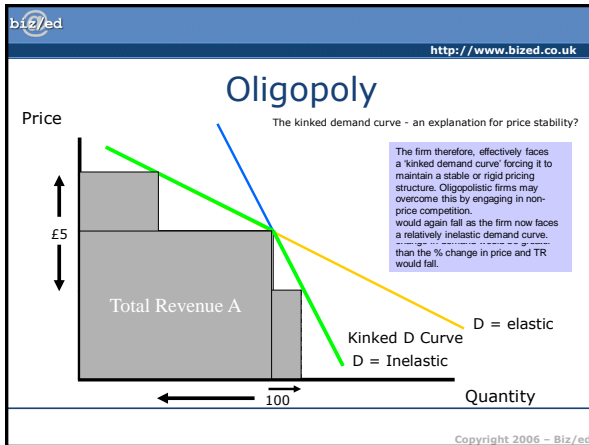
Monopolistic or Imperfect Competition

- **Characteristics:**
 - Large number of firms in the industry
 - May have some element of control over price due to the fact that they are able to differentiate their product in some way from their rivals – products are therefore close, but not perfect, substitutes
 - Entry and exit from the industry is relatively easy – few barriers to entry and exit
 - Consumer and producer knowledge imperfect

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Duopoly

- Market structure where the industry is dominated by two large producers
 - Collusion may be a possible feature
 - Price leadership by the larger of the two firms may exist - the smaller firm follows the price lead of the larger one
 - Highly interdependent
 - High barriers to entry
 - Cournot Model - French economist - analysed duopoly - suggested long run equilibrium would see equal market share and normal profit made
 - In reality, local duopolies may exist

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Monopoly

- Pure monopoly - where only one producer exists in the industry
- In reality, rarely exists - always some form of substitute available!
- Monopoly exists, therefore, where one firm dominates the market
- Firms may be investigated for examples of monopoly power when market share exceeds 25%
- Use term 'monopoly power' with care!


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Monopoly

- Monopoly power - refers to cases where firms influence the market in some way through their behaviour - determined by the degree of concentration in the industry
 - Influencing prices
 - Influencing output
 - Erecting barriers to entry
 - Pricing strategies to prevent or stifle competition
 - May not pursue profit maximisation - encourages unwanted entrants to the market
 - Sometimes seen as a case of market failure


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Monopoly

- **Origins of monopoly:**
 - Through growth of the firm
 - Through amalgamation, merger or takeover
 - Through acquiring patent or license
 - Through legal means – Royal charter, nationalisation, wholly owned plc

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Monopoly

- Summary of characteristics of firms exercising monopoly power:
 - **Price** – could be deemed too high, may be set to destroy competition (destroyer or predatory pricing), price discrimination possible.
 - **Efficiency** – could be inefficient due to lack of competition (X- inefficiency) or...
 - could be higher due to availability of high profits


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Monopoly

- **Innovation** - could be high because of the promise of high profits, Possibly encourages high investment in research and development (R&D)
- **Collusion** – possible to maintain monopoly power of key firms in industry
- High levels of branding, advertising and non-price competition

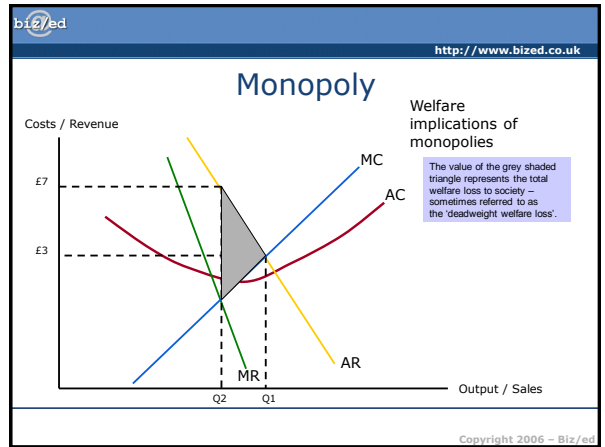
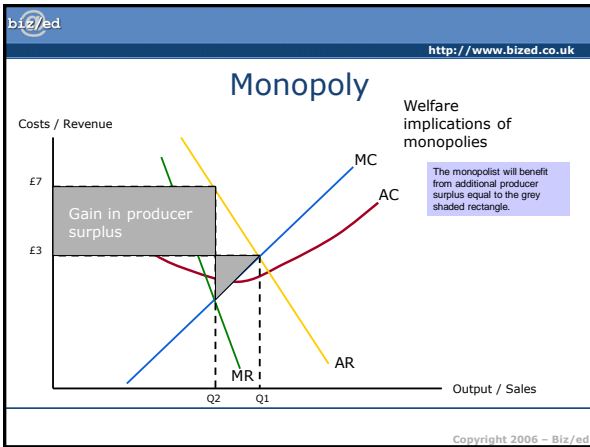
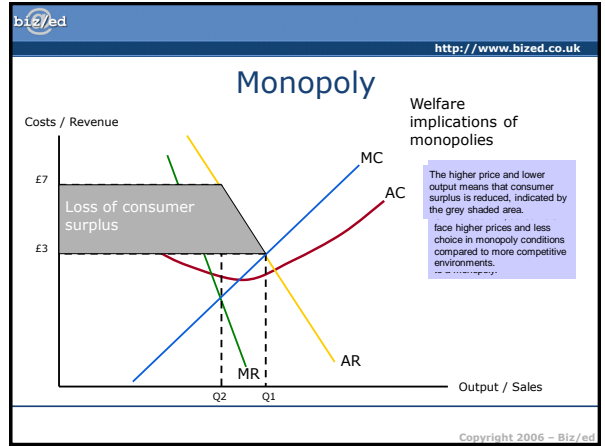
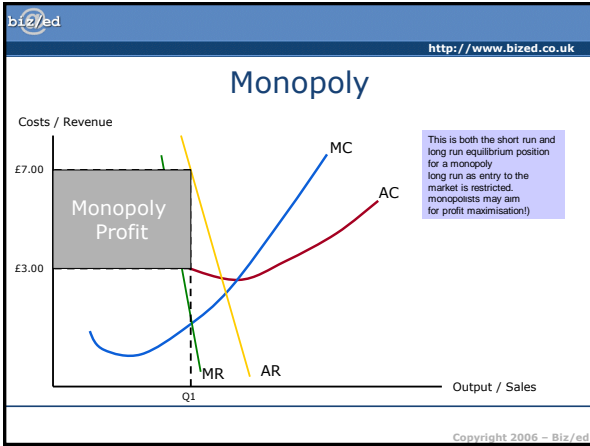
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Monopoly

- **Problems with models – a reminder:**
 - Often difficult to distinguish between a monopoly and an oligopoly – both may exhibit behaviour that reflects monopoly power
 - Monopolies and oligopolies do not necessarily aim for traditional assumption of profit maximisation
 - Degree of contestability of the market may influence behaviour
 - Monopolies not always 'bad' – may be desirable in some cases but may need strong regulation
 - Monopolies do not have to be big – could exist locally

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Contestable Markets

- Theory developed by William J. Baumol, John Panzar and Robert Willig (1982)
- Helped to fill important gaps in market structure theory
- **Perfectly contestable market** – the pure form – not common in reality but a benchmark to explain firms' behaviours

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Contestable Markets

- **Key characteristics:**
 - Firms' behaviour influenced by the threat of new entrants to the industry
 - No barriers to entry or exit
 - No sunk costs
 - Firms may deliberately limit profits made to discourage new entrants – entry limit pricing
 - Firms may attempt to erect artificial barriers to entry – e.g...


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Contestable Markets

- **Over capacity** – provides the opportunity to flood the market and drive down price in the event of a threat of entry
- **Aggressive marketing and branding** strategies to 'tighten' up the market
- Potential for **predatory** or **destroyer pricing**
- Find ways of reducing costs and increasing **efficiency** to gain competitive advantage


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Contestable Markets

- **'Hit and Run' tactics** – enter the industry, take the profit and get out quickly (possible because of the freedom of entry and exit)
- **Cream-skimming** – identifying parts of the market that are high in value added and exploiting those markets


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Contestable Markets

- Examples of markets exhibiting contestability characteristics:
 - Financial services
 - Airlines – especially flights on domestic routes
 - Computer industry – ISPs, software, web development
 - Energy supplies
 - The postal service?

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Market Structures

- Final reminders:
 - Models can be used as a comparison – they are not necessarily meant to BE reality!
 - When looking at real world examples, focus on the behaviour of the firm in relation to what the model predicts would happen – that gives the basis for analysis and evaluation of the real world situation.
 - Regulation – or the threat of regulation may well affect the way a firm behaves.
 - Remember that these models are based on certain assumptions – in the real world some of these assumptions may not be valid, this allows us to draw comparisons and contrasts.
 - The way that governments deal with firms may be based on a general assumption that more competition is better than less!

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