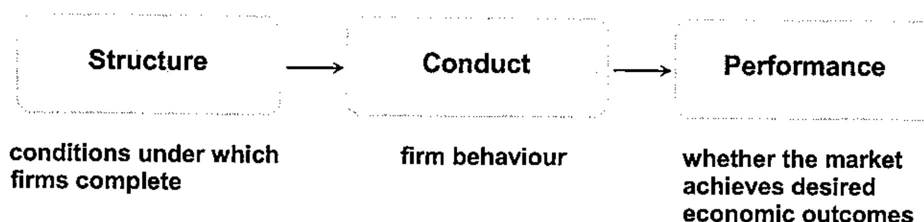
Markets in practice

Read pages 78–86 of the textbook.

Market stuctures

There are a range of different markets, each with their own particular characteristics. They vary from markets with a large number of firms competing with each other to markets with only a few firms who dominate a market. The structure of a market refers to the size, shape and relative strength of firms in that market. The structure of a market determines the conduct of firms in that market. An understanding of firm behaviour allows for an analysis of whether that market is meeting the needs of consumers and producers.

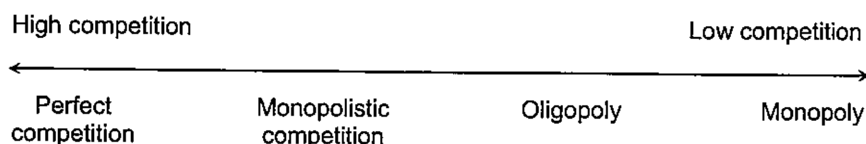


Although there is a wide range of markets, economists have developed four models of different market types. They are:

- perfect competition
- monopolistic competition
- oligopoly
- monopoly.

It is important to realise that these are only models. In reality, although there may be very close examples, actual markets won't be exactly as described in theory. However, actual markets can be compared to these models to gain some insight into their operation.

The main characteristic distinguishing the four types of market is the level of competition.



Level of competition distinguishes the four types of market

Characteristics of market structure

Number of firms

The number of firms in a market is a key characteristic of a market structure. The greater the number of firms, the higher the level of competition and the less influence each firm has on market behaviour. The number of firms will depend partly on the conditions of entry into that market.

Conditions of entry

The conditions of entry dictate the number of firms in that market. If it is relatively easy to set up a business, the market will be comprised of many firms. If there are significant barriers to entry such as cost, capital requirements, technology, legal requirements or competition from established firms, then there are likely to be fewer firms in the market.

Degree of product differentiation

Product differentiation refers to the characteristics of the product in question. In some markets, firms are selling identical products with no product differentiation. In other markets, firms are able to differentiate their product from competitors on the basis of advertising, packaging, customer service and so on.

Control over price

Another key characteristic of a market is the degree of control an individual firm has over price. The greater the number of firms, the less control each has over market price. As the number of firms decreases, the ability of individual firms to influence market price increases.

Types of market structure

Perfect competition

The characteristics of perfect competition are:

- a large number of buyers and sellers
- there are no barriers to entry into the market – firms can easily enter or leave the market
- the products of each firm are identical (or homogeneous)
- no firm has significant influence over market price – producers are 'price takers'.

In the real world there is no one industry that is perfectly competitive. The closest examples are found in agriculture. The market for carrots is a good example.

Large number of buyers and sellers

There are a large number of market gardeners producing carrots for the market. There is also a large number of buyers, ranging from large supermarket chains to small local shops.

No barriers to entry

There are no significant barriers to entry. Anyone who wants to grow carrots needs only a little knowledge and capital. Although there are some larger producers, even backyard gardeners can enter the market by planting carrots and selling them.

Identical product

Sellers are producing an identical product – there is no difference to the buyer between one grower's carrots and another grower's. If all producers' carrots are the same, buyers will expect to pay the same price.

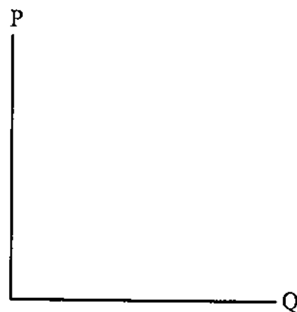
No control over price (price taker)

As each producer contributes only a small amount to the total, no individual has any control over price. They are perfect substitutes. If one grower decided to sell at a higher price, buyers would just go to the next producer and get what they need at the lower price. This means they face a perfectly elastic demand curve.

Note: This is one example where theory doesn't quite match reality. Large buyers of carrots, such as big supermarket chains, may demand lower prices in return for offering a regular market, and therefore have some influence over price.

Activity 1

1. Explain why sellers in a perfectly competitive market are price takers, using an appropriate demand curve diagram.



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2. In what ways is the tomato market close to being perfectly competitive? Briefly explain why.

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Monopolistic competition

The characteristics of monopolistic competition are:

- a large number of small firms
- products are not identical, but are differentiated
- no significant barriers to entry into the market
- firms have some control over price.

Monopolistic competition describes a large number of actual industries in Australia. One example is restaurants.

A large number of small firms

As in perfect competition, there are a large number of producers. No one seller dominates the market so firms have limited influence over the price. There are thousands of restaurants in Australia, ranging from fast foods to fine dining, local restaurants to worldwide franchises. The amount of influence a particular restaurant has over its prices will depend on the extent of product differentiation.

Product differentiation

In monopolistic competition, products are not identical but are slightly differentiated. Firms aim to make their product different from their competitors, so the products are not perfect substitutes. Producers compete for a share of the market through simple advertising (such as fliers), packaging, product quality, good service and so on. In effect, each firm tries to create a monopoly for its own product. For example, a fine dining restaurant will charge higher prices because it claims its food is superior, there is better table service, the 'atmosphere' is better, and so on. Fast food restaurants, however, compete on the basis of being cheaper and more convenient.

No significant barriers to entry to the market

Entry into the market is relatively easy. Although a reasonable level of finance and expertise may be needed to start a restaurant, there are few legal or technical barriers. New entrants will need to be able to differentiate their product and advertise their brand to win new customers.

Firms have some control over price

Although there is competition, product differentiation is used by sellers to convince customers that their product is unique. This allows them to have some say in the prices they charge. For example, some consumers are willing to pay extra for certain features offered by fine dining restaurants. These restaurants can't charge prices that are too high, however, as there are substitutes available and they will lose sales. For this reason, firms in monopolistic competition face an elastic demand curve.

(Note that the demand curve is not perfectly elastic as in perfect competition, firms in monopolistic competition use product differentiation to try and reduce elasticity.)

Activity 2

1. What is the main difference between monopolistic competition and perfect competition? Use an example to explain your answer.

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2. Explain the importance of advertising to businesses in monopolistic competition.

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Oligopoly

The characteristics of oligopoly markets are:

- a few firms supply most of the market
- a high degree of product differentiation
- significant barriers to entry
- significant control over price.

There are a number of industries in Australia that fall into the category of oligopoly. An example is car manufacturers.

Few firms supply most of the market

In Australia, there are four main car manufacturers that supply nearly 75% of the local market. Each firm has a large share of market sales. There is competition from imported cars, but they are relatively insignificant. As each firm has a large market share, the decisions of one firm have a significant influence over the behaviour of the other firms. This means that firms in an oligopoly are interdependent. For example, if one car manufacturer offers a longer warranty, it is likely that the other manufacturers will follow suit to avoid losing market share.

High degree of product differentiation

Firms in an oligopoly market compete for market share by differentiating their product from competitors. They aim to compete on the basis of quality, reliability, brand image, design, advertising, packaging and so on. Car manufacturers, for example, compete heavily through advertising, trying to convince potential consumers that their cars are better designed, more reliable or safer than their competitors. They may also advertise to promote a certain image and retain brand loyalty. There are also other forms of non-price competition such as warranties and after sales services. In addition car manufacturers spend large sums on research and development to further differentiate their product.

Significant barriers to entry

Significant barriers to entry make it difficult for new firms to enter an oligopoly market. These might include start up costs, legal requirements, competition from existing firms and economies of scale. The existing car manufacturers enjoy economies of scale. This means they are able to produce their products relatively cheaply due to their large scale operations. The cost of each car decreases as more cars are manufactured because the manufacturer can use the same factory and equipment to produce more cars. They can also buy raw materials cheaper in bulk. New manufacturers cannot compete with the lower costs enjoyed by the established firms.

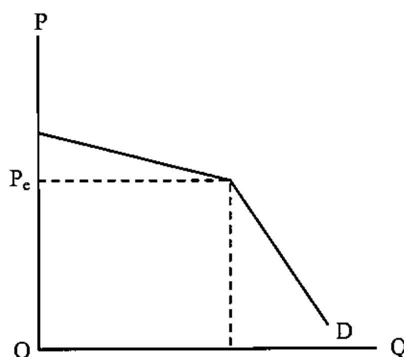
Another barrier is high start up costs. A new firm would require extensive finance to establish new plant and machinery for production. They would also require licences and have to meet strict legal requirements in terms of car design, workplace practices and so forth.

If these barriers failed to deter a new entrant, existing firms may use their market power to drive down prices. They would be able to suffer temporary losses in the hope of forcing the newcomer out.

Significant control over price

Firms in an oligopoly market have a significant influence over price due to the lack of competition and their ability to differentiate their product. They generally avoid price competition, preferring to let prices gradually rise together. There may be an incentive for price collusion. This is where firms come to an agreement on price. Collusion is illegal in Australia as it is anti-competitive.

The interdependence of firms means that sudden price changes will be temporary because price wars are destructive for all firms. For example, if one firm lowers its price, the other firms will promptly follow suit to maintain market share. There is little incentive for one firm to raise its prices because the other firms will be happy to remain at the old price and let that firm lose market share. This is shown by a 'kinked' demand curve as shown below:



If one firm raises its price above OPe, it is unlikely that the others will follow. Buyers will substitute into other products and the firm will rapidly lose sales. Consequently, the demand curve above the market price is relatively elastic. If, however, one firm decides to lower its price, the other firms rapidly follow. This part of the demand curve therefore is inelastic.

Activity 3

1. What is meant by 'interdependence of firms'?

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2. What is non-price competition and why is it important in oligopolies?

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3. If, in an oligopoly market, one firm raises its prices, what are its competitors likely to do? Explain why.

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Monopoly

The characteristics of monopoly markets are:

- one firm supplies the whole market
- the product has no close substitutes
- entry to the market is blocked
- control over price.

A monopoly is the extreme opposite of perfect competition. Most monopolies are very large firms, some created by governments. There are also local or regional monopolies in isolated areas where there is only one supplier within close reach. There are not many true monopolies in Australia but ACI, which produces 96% of Australia's glass containers, provides a close example.

One firm supplies the whole market

In a true monopoly, one firm supplies the whole market. This may happen in a country town where there is only one doctor, baker or supermarket. National monopolies are rare, however. In the past, government statutory bodies providing public goods such as water or electricity have been monopolies, but many of these have now been opened up to competition. For example, there are now a number of electricity suppliers who all share existing infrastructure (such as electricity poles and lines).

Product has no close substitutes

A monopoly is where there is only one seller of a good that has no close substitutes. This means that consumers have no choice as there are no alternatives. In reality, however, this is unusual. For example, although ACI manufactures most glass containers in Australia, consumers could turn to imported containers if they needed to.

Entry to the market is extremely difficult

There are significant barriers to entry in a monopoly that prevent competitors from entering the market. An example is monopolies created by law. Governments have sometimes set up monopolies to deliver public utilities such as water or electricity. Potential competitors were blocked by legislation. This was done to reduce costs using economies of scale or to provide rural areas with essential services. In other cases patents protect particular inventions or processes and prevent competition for a period of time.

Another barrier to entry is significant economies of scale. Economies of scale mean that lower average costs of production can be achieved in large scale production. A monopolist is likely to be very large and able to produce at a low cost. Any new producers would find it difficult to match the economies of scale enjoyed by a monopoly company as it dominates the market. The existing monopoly may also use its market power to set unrealistically low prices to force out new competitors.

Control over essential resources by a monopoly may also be used to maintain its position. In addition, there may be enormous start up costs for a new competitor to break into the market.

Control over price (price maker)

A monopoly market is one where the seller has enough market power to completely control the price of the product. They are sometimes referred to as a 'price maker'. A monopoly can set the price or quantity sold but not both. Consumer demand will determine how much is sold at a given price. The demand curve will be relatively inelastic as there are no close substitutes.

Excessive market prices are usually avoided through fear of government intervention or competition from overseas. In addition, economies of scale reduce production costs and allows lower prices.

Activity 4

1. Use a diagram of an inelastic demand curve to explain why a monopolist can't set both price and quantity.

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2. Explain why monopolists may be referred to as 'price makers'.

Activity 5

Select two of the following industries and determine which type of market that industry belongs to, using the features discussed above. You may need to do some research. Be prepared to discuss your answer in lesson.

Lawn mowing services	Shares
Eggs	Banks
Hairdressers	Whitegoods
Colonial Sugar Refinery (CSR)	Doctors
Domestic airlines	Australia Post

Activity 6

Complete the table below to summarise the features of the different markets.

Features of markets				
Feature	**Perfect competition**	**Monopolistic competition**	**Oligopoly**	**Monopoly**
Number of firms				
Degree of product differentiation				
Barriers to entry				
Control over price				
Elasticity of demand curve				
Examples				

Activity 7: Review questions

1. A key feature of oligopolies is:
   - J. ease of entry into the market
   - K. a large number of small firms
   - L. non-price competition
   - M. perfectly elastic demand.

2. Which of the following is not a characteristic of monopolistic competition?
   - J. identical products
   - K. few barriers to entry
   - L. a large number of sellers
   - M. non-price competition.

3. In a monopoly:
   - J. both price and non-price competition is used
   - K. firms face an elastic demand curve
   - L. there is interdependence between firms
   - M. there are no close substitutes.

4. A characteristic of perfect competition is:
   - J. there are no close substitutes
   - K. there is perfectly elastic demand
   - L. supply is inelastic
   - M. firms keep a close eye on each other's behaviour.

5. A market with a small number of firms supplying differentiated products is known as:
   - J. perfect competition
   - K. monopolistic competition
   - L. an oligopoly
   - M. a monopoly.