Market Structures

RIDLEY COLLEGE
SINCE 1889

Assessment Objectives

Specific Expectations	
AO2	Explain the main characteristics of perfect competition – many firms, free entry, homogeneous products
AO2	Explain the main characteristics of monopoly – single or dominant firm, high barriers to entry, no close substitutes
AO2	Explain the main characteristics of market structures in imperfect competition: varying degrees of market power , firm is price maker. Monopolistic competition – many firms, free entry, product differentiation. Oligopoly – few large firms, high barriers to entry, interdependence.
AO2	Explain the meaning of market power

Market power and market failure

- **Firms** are organizations that employ the factors of production to produce and sell a good or service.
- A group of one or more firms producing identical or similar goods or services is an **industry**.
    - **Example:** The car industry consists of car manufacturer (Ford, Honda, Mercedes, etc.)
- Industries are analysed by use of models called **market structures**, which describe the characteristics of a market organization that determines the behaviour of firms.
- **Market power** is the extent to which each individual firm in the industry is able to control the price at which it sells its product.
    - **Perfect competition** where firms have no ability to control the price of their products; such firms have zero market power.

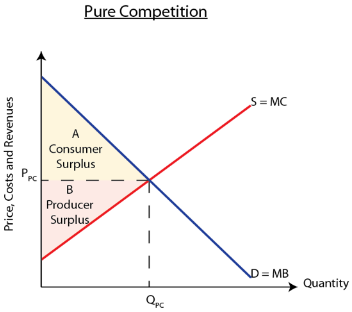
Market power and market failure

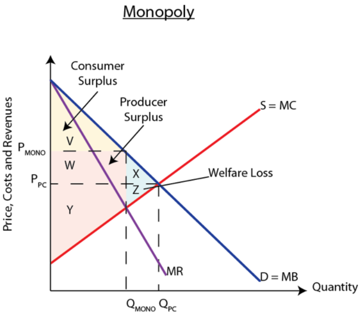
- Competition occurs when there are many buyers and sellers acting independently, so that no one has the ability to influence the price of the product.
- **Monopoly** where there is a single firm in the market; this firm has the greatest ability to control the price of its product, and therefore has the greatest amount of market power.
- In between the two extremes are two other market structures (monopolistic competition and oligopoly) where firms face some competition but also have market power, and for this reason they are known as **imperfect competition**.

- Firms in perfect competition, which have zero market power, do not result in market failure, and are the only market structure where firms achieve allocative efficiency.
- Firms in the other market structures result in market failure to varying degrees, with monopoly resulting in the greatest degree of allocative inefficiency.

Market power and market failure

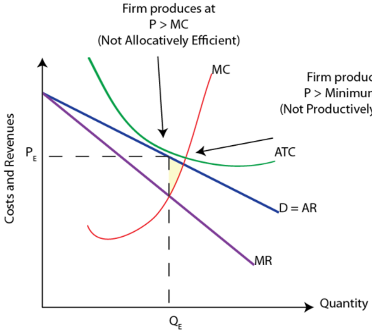
- Monopolistic producers gain at the expense of consumers.
  - Consumer surplus shrinks from A to V in the monopoly
  - Producer surplus expands from B under perfect competition to W + Y under the monopoly
  - Triangle X represents the welfare loss to the consumer and Z the welfare loss to the producer (loss of surplus for producers)

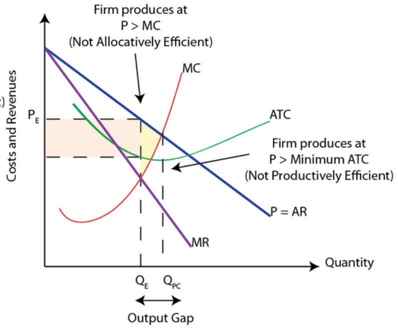




Market power and market failure

- Imperfectly competitive firms achieve neither allocative nor productive efficiency.
  - P $>$ MC (Allocative inefficiency)
  - P $>$ Min ATC (Productive inefficiency)





Market Structures

- Market structures can be defined on the basis of four main characteristics:
  1. **Market power**
     - The extent to which each individual firm in the industry is able to control the price at which it sells its product.
  2. **Number of firms in the industry**
  3. **Product differentiation**
     - Occurs when each firm in an industry tries to make its product different from those of its competitors; usually in order to create some market power (monopoly power).
     - Products can be differentiated by physical differences, quality differences, location, services and product image.
  4. **Barriers to entry**
     - Anything that can prevent a firm from entering an industry and beginning production, as a result limiting the degree of competition in the industry. **Free entry** occurs where there are no barriers to entry.

Entry Barriers

- **Entry Barriers** – are economic or institutional obstacles to businesses entering an industry.
  - There are six main entry barriers in **imperfect competition**:
    1. Increasing returns to scale
    2. Market experience
    3. Restricted ownership of resources
    4. Legal obstacles (**Example:** Patents)
    5. Market abuses (**Example:** Predatory pricing)
    6. Advertising (most common in oligopolies)

Perfect Competition

- **Perfect Competition** is a market structure in which the decisions of buyers and sellers have no effect on the market price.
  - There is a very large number of firms in the industry.
  - All firms in the industry sell **homogeneous** products; this means the products are identical (undifferentiated); there are no brand names.
  - There are no barriers to entry; any firm that want to enter the industry and begin producing the good or service can do so freely.
    - Perfect competition is highly unrealistic and it is difficult to find markets in the real world that meet the characteristics.
    - **Example(s):** Agriculture market, commodity market and foreign exchange market.

Monopolistic Competition

- **Monopolistic Competition** is a market type in which a large number of firms compete with each other by making similar but slightly different goods and services.
  - There is a fairly large number of small or medium-sized firms in the industry.
  - There are no barriers to entry; any new firm can enter the industry.
  - There is product differentiation; each firm tries to make its product different from those of the other firms in the industry in terms of various characteristics like the quality, servicing or packaging.
  - These firms use product differentiation to gain some control over the price of their products. However, the existence of other similar products limits the degree of its power to control the market prices.
  - **Example(s):** Shoe, clothing, detergent, computer, and restaurant industries.

Oligopoly

- **Oligopoly** is a market structure in which small numbers of producers compete with each other and face strategic interdependence.
  - There is a small number of large firms in the industry; because of their small number, the firms are interdependent, because the action of one firm affects others.
    - This means that each firm tries to predict what the rival firms will do.
    - Firms base their actions on the observed or anticipated actions of rival firms.
  - Products may be either differentiated or undifferentiated.
  - There are high barriers to entry; it is difficult for a new firm to enter the industry.
  - **Example(s):** Car industry, airlines, electronic equipment and the oil, steel, aluminum, copper and cement industries.

Monopoly

- **Monopoly** a market structure with a single supplier that comprises the entire industry. There is no competition and the product produced is unique.
  - Monopolists have significant control over the price of the good/service.
  - There is a single seller or dominant firm in the industry, so the single firm is the entire industry.
    - In the real world, a monopolistic industry may consist of one firm that dominates the market with a very large market share.
  - The firm produces and sells a unique good, with no close substitutes.
    - If substitute goods existed, then consumers could switch to buying the substitute, and there would no longer be a monopoly of the good.
  - There are high barriers to entry in the industry; the monopoly owes its dominance in the market partly to the inability of other firms to enter.
  - **Example(s):** Telephone, water and electricity companies in the areas where they operate as a single supplier (Natural monopoly).

Market Structure: Summary

	Number of firms	Type of product	Ease of entry	Market power	Degree of competition	Examples
Perfect competition	Many	Homogeneous	Very easy	None	Perfect	Agriculture
Monopolistic competition	Relatively many	Differentiated	Very easy	Some	Good amount	Restaurants
Oligopoly	Few	Ambiguous	Very difficult	Significant	Some	Cars
Monopoly	One	Unique	Very difficulty	Very Significant	None	Utilities