

## Chapter-27

### Market Structure and Competition—Introduction

We have discussed that the theory of supply and demand is a theory of price in competitive markets. In this lesson, we will discuss how the supply curve is determined by price competition and profit maximization.

We can now study what economists call "industrial organization," i.e. the study of industries, including their organization and structure, how they conduct business, how they respond to change and evolve, and how efficiently they perform.

Economists believe all these things are interrelated, so this is sometimes called a structure/conduct/performance approach.

Slide 1



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Slide 2

### Market Structures

- Type of market structure influences how a firm behaves:
  - Pricing
  - Supply
  - Barriers to Entry
  - Efficiency
  - Competition

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Slide 3

### Market Structures

- Degree of competition in the industry
- High levels of competition-- Perfect Competition
- Limited Competition-- Monopoly
- Degrees of competition in between

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Slide 4

### Market Structure

- Determinants of market structure
  - Freedom of entry and exit
  - Nature of the product-- homogenous (identical), differentiated?
  - Control over supply/output
  - Control over price
  - Barriers to entry

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Slide 5

### Market Structure

- **Perfect Competition:**
  - Free entry and exit to industry
  - Homogenous product-- identical, so no consumer preference
  - Large number of buyers and sellers-- no individual seller can influence price
  - Sellers are price takers-- have to accept the market price
  - Perfect information available to buyers and sellers

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Slide 6

### Market Structure

- Examples of perfect competition:
  - Financial markets-- stock exchange, currency markets, bond markets?
  - Agriculture?
- To what extent?

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Slide 7

### Market Structure

**Advantages of Perfect Competition:**

- High degree of competition helps allocate resources to most efficient use
- Price = Marginal Costs
- Normal profit made in the long run
- Firms operate at maximum efficiency
- Consumers benefit

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Slide 8

## Market Structure

- **What happens in a competitive environment?**
  - New idea?-- firm makes short-term abnormal profit
  - Other firms enter the industry to take advantage of abnormal profit
  - Supply increases, price falls
  - Long run-- normal profit made
  - Choice for consumer
  - Price sufficient for normal profit to be made but no more

Slide 9

## Market Structure

- **Imperfect or Monopolistic Competition**
  - Many buyers and sellers
  - Products differentiated
  - Relatively free entry and exit
  - Each firm may have a tiny 'monopoly' because of the differentiation in their product
  - Firm has some control over price
  - **Examples:** Restaurants, professions-- solicitors etc., building firms-- plasterers, plumbers etc.

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## Market Structure

- **Oligopoly-- Competition amongst the few**
  - Industry dominated by small number of large firms
  - Many firms may make up the industry
  - High barriers to entry
  - Products could be highly differentiated-- branding or homogenous
  - Non-price competition
  - Price stability within the market-- kinked demand curve?
  - Potential for collusion?
  - Abnormal profits
  - High degree of interdependence between firms

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Market Structure

- **Examples of Oligopolistic Structures:**
  - Supermarkets
  - Banking Industry
  - Chemicals
  - Oil
  - Medicinal drugs
  - Broadcasting

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Market Structure

Measuring Oligopoly:

- **Concentration ratio**-- the proportion of market share accounted for by top 10 number of firms:
  - E.g., 5 firm concentration ratio of 80%-- means top 5 firms account for 80% of market share
  - 3 firm CR of 72%-- means top 3 firms account for 72% of market share

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Slide 13

Market Structure

**Duopoly:**

- Industry dominated by two large firms
- Possibility of price leader emerging-- rival will follow price leader's pricing decisions
- High barriers to entry
- Abnormal profits likely

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Market Structure

**Monopoly:**

- Pure monopoly-- industry is the firm
- Actual monopoly-- where firm has >25% market share
- Natural Monopoly-- high fixed costs-- gas, electricity, water, telecommunications, rail

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Slide 15

Market Structure

- **Monopoly:**
  - High barriers to entry
  - Firm controls price or output/supply
  - Abnormal profits in long run
  - Possibility of price discrimination
  - Consumer choice limited
  - Prices in excess of MC

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Slide 16

Market Structure

**Advantages and disadvantages of monopoly:**

- **Advantages:**
  - May be appropriate if natural monopoly
  - Encourages R&D
  - Encourages Innovation
  - Development of some products not likely without some guarantee of monopoly in production
  - Economies of Scale can be gained-- consumer may benefit

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### Market Structure

- **Disadvantages:**
  - Exploitation of consumer-- higher prices
  - Potential for supply to be limited-- less choice
  - Potential for inefficiency:
    - X-inefficiency**-- complacency over controls on costs

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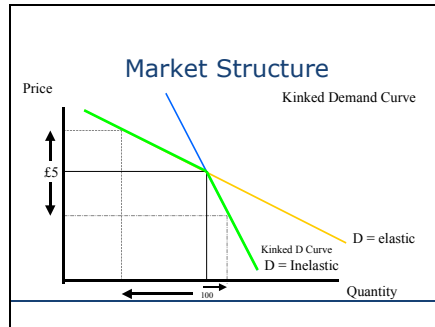
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Slide 18



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