Module 3:-Market Structure

Perfect and Imperfect Competition- Monopoly, Monopolistic Competition(Features and Equilibrium of a Firm)- Oligopoly- Kinked Demand Curve- Collusive Oligopoly(Meaning)- Non-Price Competition- Product Pricing- Cost plus Pricing- Target Return Pricing- Penetration Pricing- Predatory Pricing- Going Rate Pricing- Price Skimming

MARKET STRUCTURE AND PRICE DETERMINATION

In ordinary language, market means a place where the buyers and sellers meet to buy and sell a particular product. In other words, it is a particular place where goods are bought and sold.

The interpretation of market in Economics is different and wider. Market, in Economics is the result of a contact between the buyers and sellers, as a result of which one product of a given quantity and a trade mark is bought and sold at one place. Thus, market is an area where potential sellers are brought into contact with potential buyers through a means of exchange.

On the basis of nature and degree of competition, market is classified into three types:

1. Perfect competition
2. Imperfect competition
3. Monopoly

PERFECT COMPETITION

Perfect competition refers to a market structure characterised by the existence of a large number of buyers and sellers, engaged in buying and selling of a homogeneous commodity. In other words, it is a market situation, where there are large number of buyers and sellers producing and marketing a homogeneous product, for which a single market price is ruling. It is a market with innumerable buyers and sellers, in which, no single or set of sellers can change the entire supply.

Features of Perfect Competition

1. Large number of buyers and sellers:- In perfect competition, there will be large number of sellers and buyers. The number would be so large that no individual firm would have enough capacity to influence the price, demand or supply. The competition would be severe among innumerable sellers. In this market, the price of the commodity would be determined by demand and supply.

2. Homogenous Product:- The commodity produced and marketed by innumerable number of sellers would be same type. The price of the commodity would be same in all places and is determined by demand and supply. Firms are only the price takers and not price makers.

3. <u>Free entry and exit</u>:- In perfect competition, firms have freedom to enter or exit the industry. If the existing firms are earning supernormal profits, new firms would be attracted to enter the industry. If existing firms are incurring loss they are free to leave the industry. In this way, the firms have freedom to enter and exit from industry.

4. Perfect Knowledge:- In perfect competition, the buyers and sellers will have perfect knowledge of the market conditions. Therefore, the same price would be in force in this market.

5. Absence of selling cost:- Because of the complete knowledge of the market situation, there will not be much ado about the advertisement.

6. Absence of Transport Cost:- Perfect competition assumes complete absence of transport costs in the production and supply of goods. Therefore, price of the product is not affected by the cost of transportation of goods.

7. Perfect Mobility of factors of production:- In perfect competition, the factors of production can move freely. That is, they move from one use to another and from one place to another freely. There are no restrictions on the movement of the factors of production.

8. No Govt. Regulations:- There is no Govt. intervention in the market. Tariffs, subsidies, rationing of production and so on are ruled out.

9. Uniform Price:- In perfect competition, the price of the product would be same at all places. This price is determined by the forces of demand and supply. So all the firms will have to follow the same price.

10. Profit Maximisation:-The main goal of all the firms in the industry is profit maximisation.

11. Price Taker:-

Equilibrium of the firm and industry under perfect competition

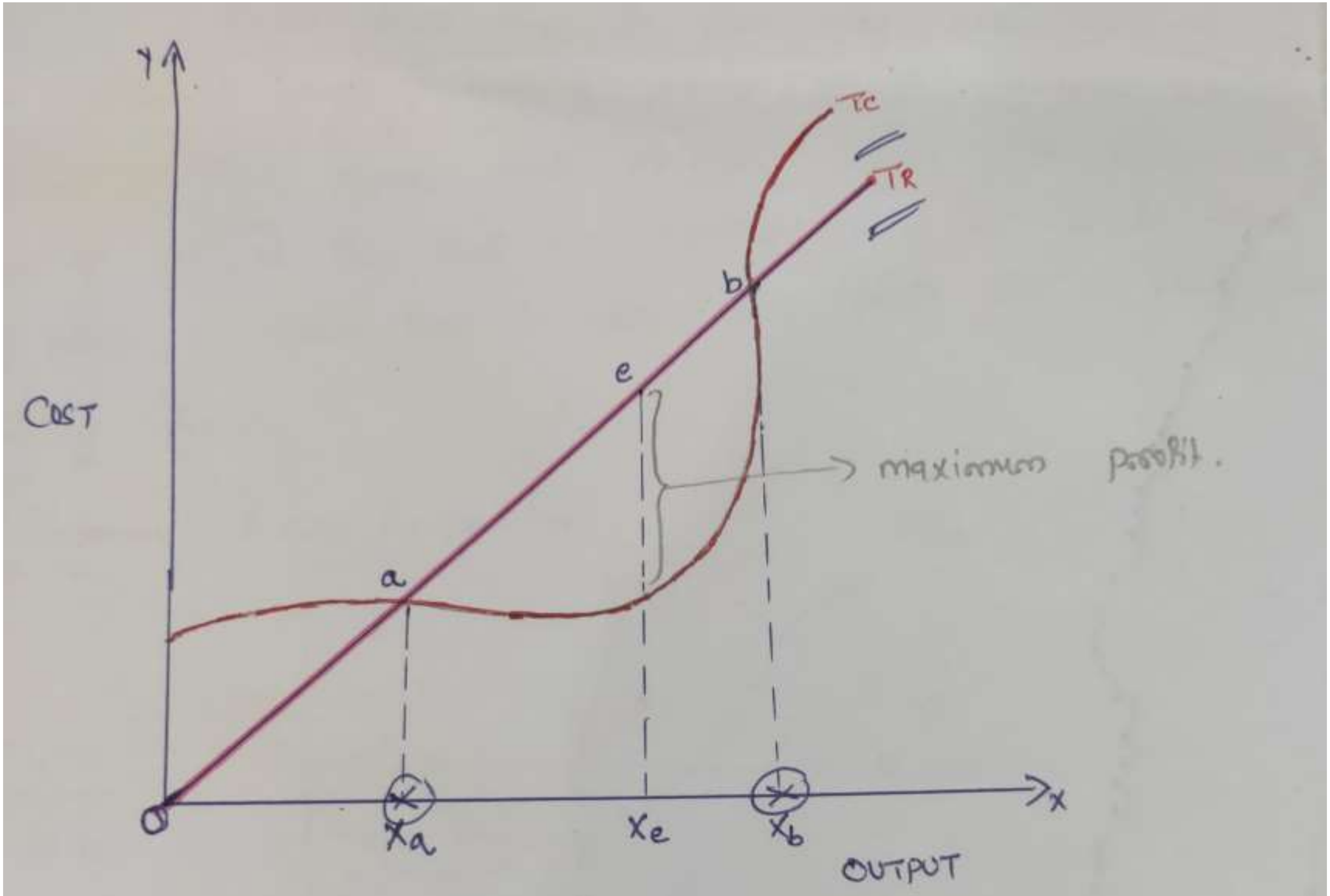
A firm is in equilibrium when it has no tendency to change its output. A firm is in equilibrium when MC=MR=AR=P.

When industry is in equilibrium, there is no tendency for the firm either to leave or to enter the industry.

Equilibrium of the Firm

A firm is in equilibrium when it maximises its profit(TR-TC). The equilibrium of the firm may be explained with the help of graphs in two ways:

1. TC&TR Curve Approach:- Profit is the difference between Total revenue and Total Cost. A firm will maximise profit at a level of output where the difference between Tr and TC.



Y
TC
TR
b
e
COST
maximum profit.
a
O
X
X_a
X_e
X_b
OUTPUT

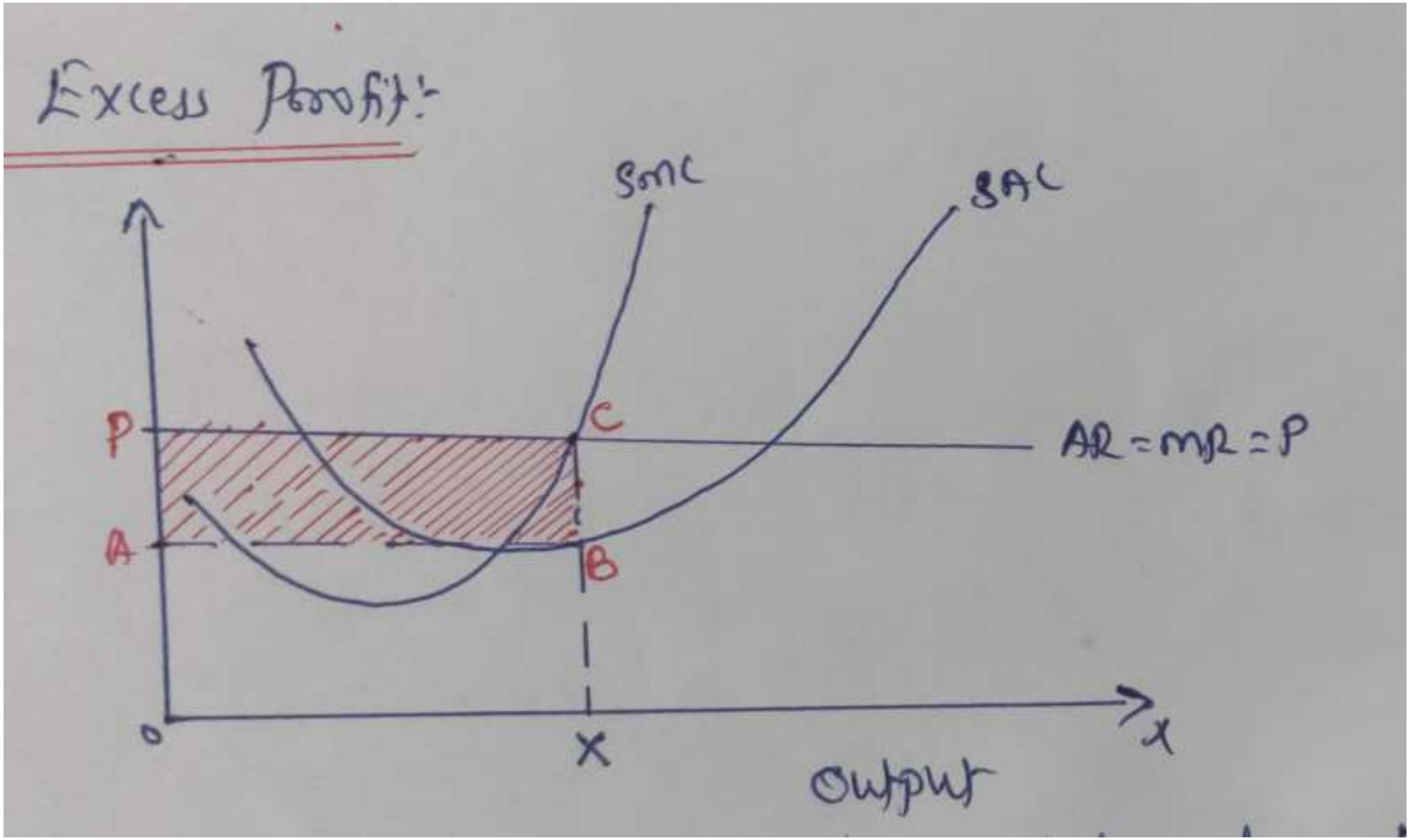
In the above figure, TR is a straight line starting from the origin showing that price is constant at all levels of output. The shape of TC curve is inverted ‘S’ shape. The firm maximises its profit at the output ‘X_e’ where the distance between TR&TC curve is large. If the output is smaller than ‘X_a’ or higher than ‘X_b’, the firm suffers from loss. TR=TC is the Break-Even point of the firm.

2. **MC & MR Curve Approach**:- A firm is in equilibrium, when the following marginality conditions are satisfied:-

1. MC=MR &
2. MC must cut MR from below.

- Short-run Equilibrium of the Firm:- In the short-run, the firm may earn abnormal or supernormal profit, normal profit or it may incur losses. Whether a firm makes profit or loss depends on the difference on the level of AC curve at the short-run equilibrium. If AC of the firm lies below the price line, it earns excess profit that is shown in the figure.

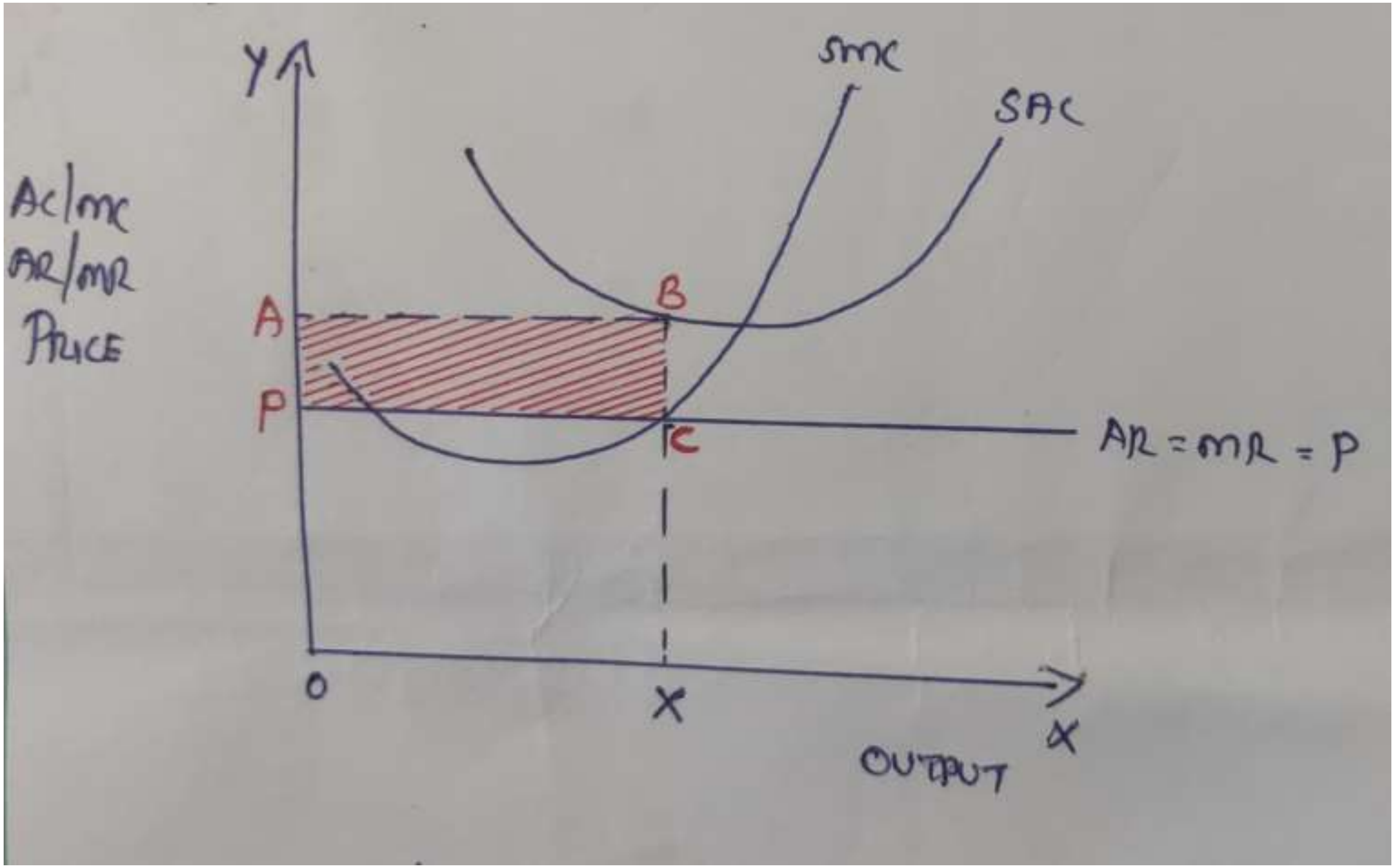
Abnormal/Excess Profit



In the above figure, output is taken along the ‘x’ axis and AC/MC/AR/MR & Price along the ‘y’ axis. The firm reaches equilibrium when it produces ‘ox’ amount of the output at which two marginality conditions are satisfied(ie, MC=MR and MC must cut MR from below.) As the SAC curve is situated at a level lower than the AR(price) curve, the firm is enjoying abnormal profit at the point of equilibrium to the tune of PABC.

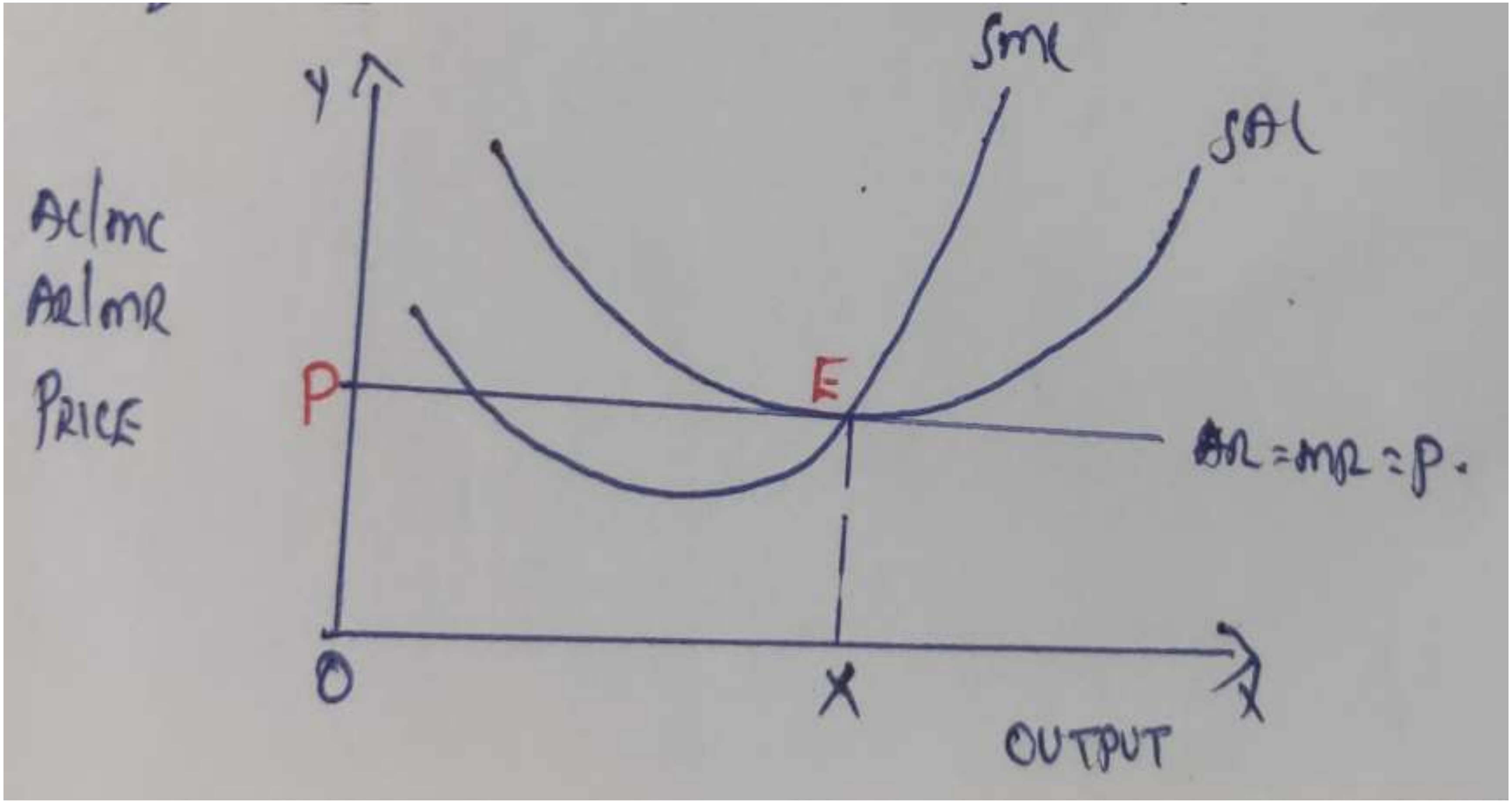
Loss

If AC curve is placed above AR curve, even at equilibrium, the firm may incur losses as shown in the following figure:



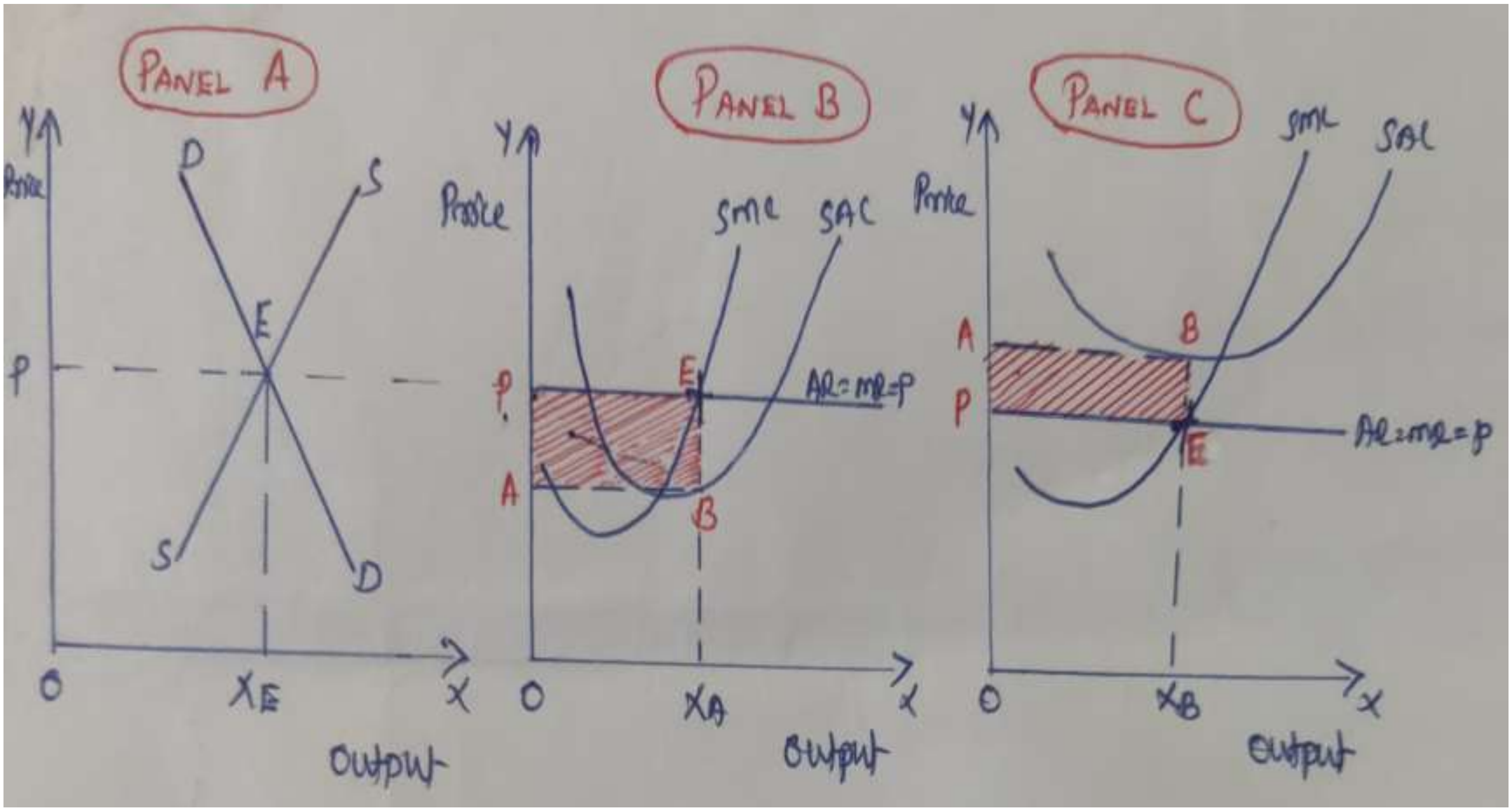
Normal Profit

If AC curve is tangent to the AR curve, the firm earns only normal profit at the point of equilibrium price and quantity of output. It is depicted in the following figure.

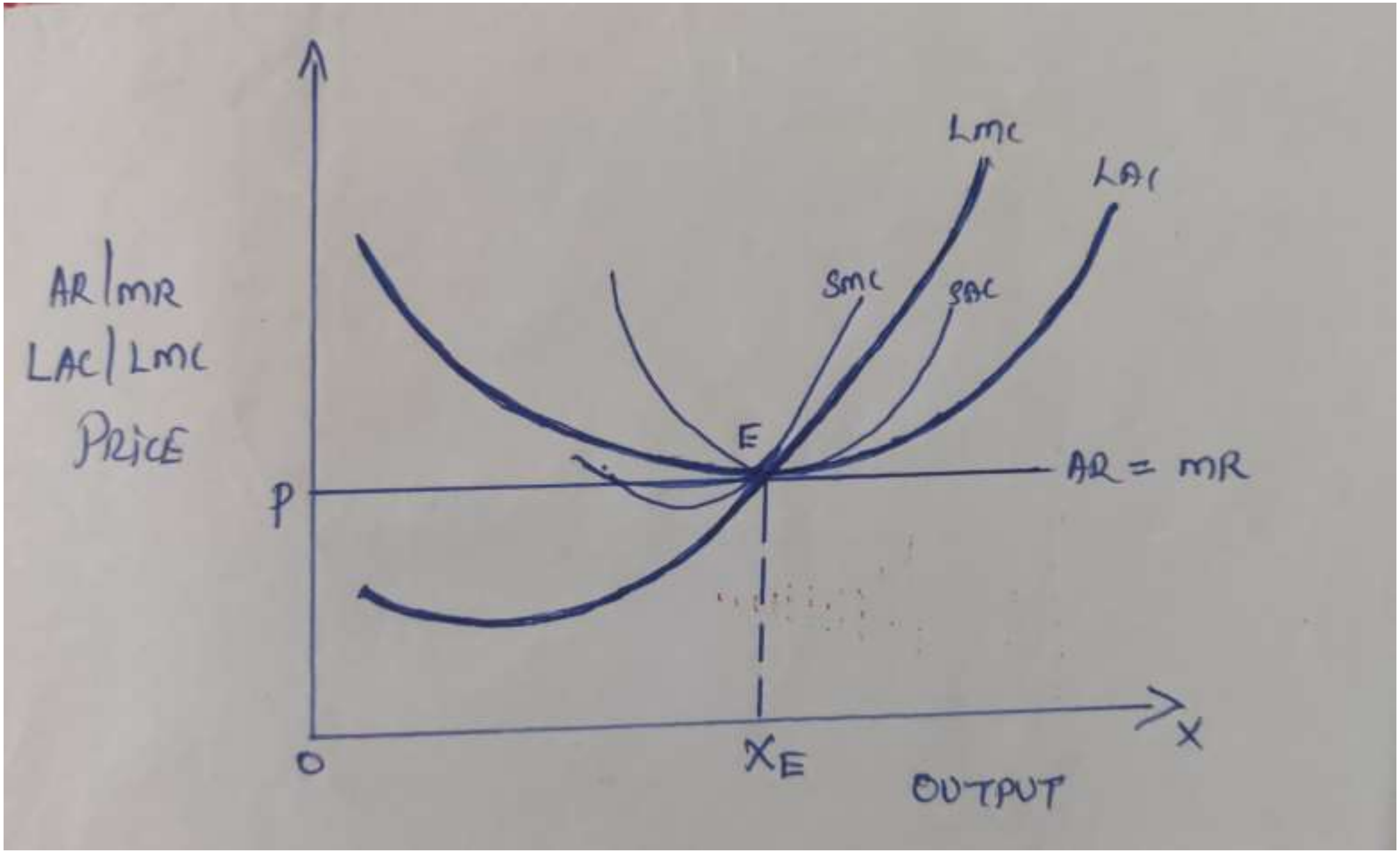


Short run Equilibrium of the Industry:-

The industry is in equilibrium at the price which clears the market, that is at the price at which quantity demanded is equal to quantity supplied. If the industry is in equilibrium at the prevailing price, firms may be making excess profits or normal profits or even incurring losses.



Long run Equilibrium of the firm:- In the long run, the firm will be earning only normal profit. Because of free entry and exit of firms and buyers.



Equilibrium of the Industry in the long run:-

When the industry reaches equilibrium in the long run, there will not be any further entry or exit of firms in the industry.