MODULE - 3

Perfect & Imperfect Competition.

Perfect Competition

- Implies no rivalry among firms.
- Can be defined as a market structure characterized by complete absence of rivalry among the individual firms.
  i.e, perfect competition is a market structure where there is a perfect degree of competition & single price prevails.
- perfect competition market is a market structure where in every seller takes the market prices as the price of his own product. firms are incapable of influency the market price either by acting singly or in a group.

Features.

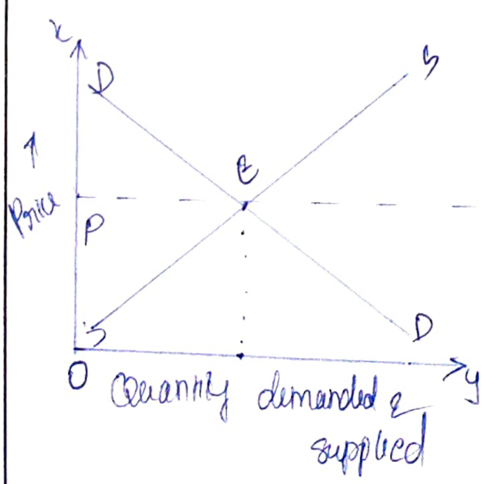
1) Homogeneous product
2) Large number of sellers
3) Large number of buyers
4). Full knowledge of market

5) Economic rationality
6) Free entry and exit.

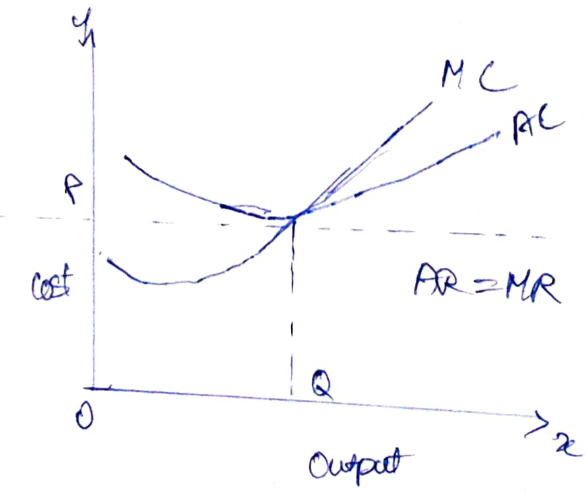
Price and Output determination under perfect competition.

- Price of commodity is determined by the interaction of demand & supply not by any one seller or a firm.
- The price at which demand and supply are equal is known as an equilibrium price since at this price the forces of demand and supply are balanced or are in equilibrium.
- The quantity bought and sold at this equilibrium price is known as equilibrium amount.

Demand curve under perfect competition



(a) Industry



b) Firm

- In fig(a), the total demand curve DD intersects industry's supply curve SS at point 'E'. Thus point E is the equilibrium point & OP is the equilibrium price.
- fig (b) refers to firms demand curve. The firm will have to sell all its input at the prevailing price OP. It may sell more units or less units, but it will charge OP price only. The firm can neither increase nor decrease this price, because price is determined by the industry and not by the firm.
- Firm is a price taker & not a price maker.

Advantages of perfect competition.

- Resources are allocated in the perfect way.
- Standard products are available in the market.
- It prevents the emergence of a few rich & powerful people.
- Advertising & promotional expenses are eliminated because product is homogeneous & there is perfect knowledge among consumers

Disadvantages

- Firms are small for large scale R&D of new technology.
- There are very little barriers to entry implying that any firm can enter the market and start selling the product.

Imperfect Competition

- Refers to a condition where the characteristics of an economic market do not fulfill all the necessary conditions of a perfectly competitive market, imperfect competition will cause market inefficiency when it happens in the market, resulting in the market failure.

- It is used to describe the seller's position, meaning that the level of competetion between seller falls for short of the level of competition in the market under ideal conditions.

- The structure of a market can significantly impact the financial performance and conduct of the firms competing with it.

Conditions of Imperfect competition.

If one of the following conditions are satisfied within an economic market, the market is considered as imperfect.

1) The market's goods & services are heterogeneous or differentiated. This means that firms can charge higher prices as their goods & services are perceived as better

2) The market contains ONE seller or more.
3) Market firms are NOT price takers and hence have some control over the pricing of their goods & services.

Market Structures

- Market is a term which is commonly used for a particular place or locality where goods are bought & sold.
- According to Prof. Samuelson, "A market is a mechanism by which buyers and sellers interact to determine the price & quantity of a good & service.
- Based on competition, the market structure has been classified as two broad categories.

1) Perfectly competitive
2) Imperfectly competitive (Monopoly, Monopolistic competition & oligopoly)

Monopoly

- The word monopoly is derived from two greek words 'mono' means single and 'polo' means to sell.
- Monopoly is a market in which a single seller sells a product which has no substitutes.

Eg: RBI, Rail transport

Features of monopoly

1) Single seller
- Single producer of a commodity.
- But the buyers of the product are in large number. Consequently, no buyer can influence the price of the product

2) Restriction on the entry of the firm
- Under monopoly, there will be some restrictions on the entry of new firms into monopoly industry.

3) Full control over price.
- Since one firm alone produces the commodity in the market, a monopoly firm has full control over its price. A monopoly firm is a price maker. He can fix what ever price he wishes to fix for his product.

4) No close substitutes.
A monopoly firm produces a commodity that has no close substitutes.

5) Possibility of price discrimination
Monopoly firms charges different prices for different consumers. It is called price discrimination.

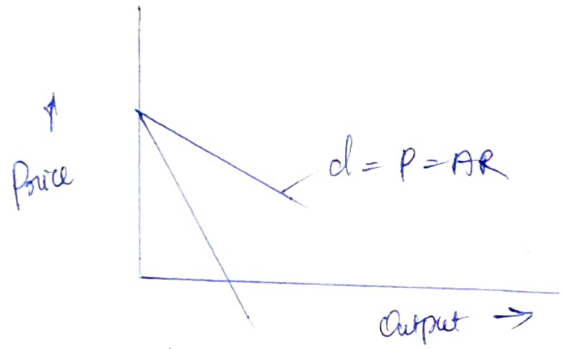
Types.

1) Natural monopoly
2) Social monopoly
3) Legal monopoly

4) Monopolies of services.

Monopolistic Competition.

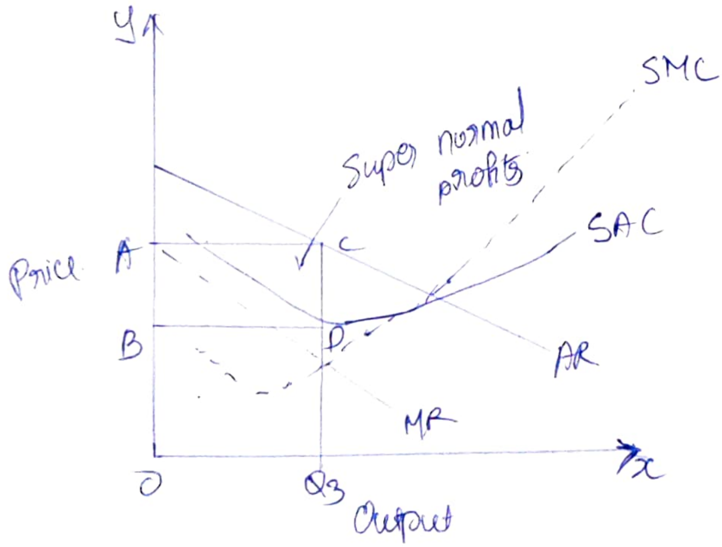
Demand curve under Monopoly.



Equilibrium under Monopoly.

- Under monopoly, for the equilibrium and price determination, there are two different conditions which are

1) Marginal revenue must be equal to marginal cost.
2) MC must cut MR from below.



Dumping

- It means a monopolist sells his product at a higher price in the home market and lower price in the international market

Regulation of monopoly

- The government may wish to regulate monopolies to protect the interests of consumers. For example, monopolies have the market power to set prices higher than in competitive markets. The government can regulate monopolies through

  - Price capping.
  - Regulation of mergers.
  - Breaking up monopolies.
  - Investigation into cartels and unfair practices
  - Nationalisation

Why the government regulates monopolies.

1) Prevent excess prices
2) Quality of service.
3) Monopsony power.
4) Promote competition.
5) Natural monopolies.

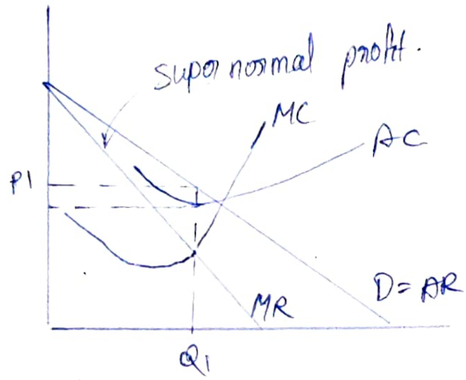
Monopolistic Competition

- It is a market structure at which large number of sellers dealing with differentiated commodities.
- The term monopolistic comp was given by Prof. Edward H. Chamberlin
- The main feature of monopolistic competition is product differentiation.
- Product differentiation means commodities marketed by each seller can be distinguished from the products marketed by other seller in the form of size, shape, brand, colour etc.

Feature of monopolistic competition.

- Large number of sellers
- Product differentiation.
- Freedom for entry and exit.
- Advertisement and selling cost (sales promotion cost)
- Lack of perfect knowledge.

There would be price-output determination under monopolistic competition.



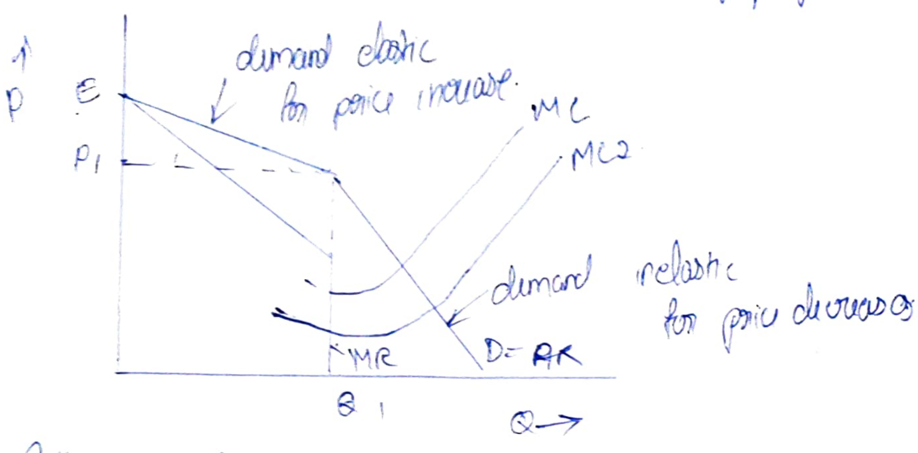
Oligopoly

- The word oligopoly is derived from greek word 'oligo' means few and 'polo' means to sell.
- It is a market with few sellers dealing with homogeneous and differentiated commodities.
- In oligopoly one firm's action will cause its competitors to react. This shows that firms has interdependence under oligopoly.

Features of oligopoly

- Few sellers
- There are barriers for entry.
- Homogeneous & heterogeneous commodities.
- Interdependence between firms.
- Independent decision making.

Price output determination under oligopoly.



Collusive oligopoly

- According to Samuelson, collusion denotes a situation where two or more firms, jointly set their prices or output, divide the market among them, or make the business decisions".

- Collusion model recognizes that oligopoly firms depends on each other for their price-output decision making. Thus they enter into some sort of agreement for the price and output level. When this agreement is formal and overt, the group of firms that operates under it for determining their price and output levels, form what is known as a cartel. Such formal agreements are however not possible in all countries.

Kinked demand curve.

The kinked demand curve illustrates the interdependence of firms in an oligopoly market.

- The reason why there is a kink in the demand curve is that there are two demand curves. One that is elastic and one that is inelastic.
- The kink occurs when both demand curves intersect each other.

Characteristics of the kinked demand curve.

1) Interdependence

- Firms make decisions based on rival firms as they are affected by the decisions of each firm in this market.
- Few firms dominate the market. There is a high concentration ratio which is greater than 50% market share.

2) High barriers to entry & exit.

- The main barriers to entry and exit are large start-up costs, sunk costs, brand loyalty and economies of scale

3) Non price competition.

- firms can't compete through prices because there are rigid

Non price competition

- Involves ways that firms seek to increase sales and attract custom through methods other than price.

Forms of non-price Competition

- loyalty card.
- subsidized delivery.
- advertising / brand loyalty
- after sales services
- coupons and free gifts.

Product pricing

- By product pricing presents an opportunity to set the right price for the by products of the main core product. so as to earn incremental revenue.

1) value based pricing.
- Basing a product or service's price on how much the target consumer believe its worth.
- Requires ample time and resources not exact.

2) Competitor based.
- Examining your competitors pricing structure as the

case bench mark for your own strategy.

Detached from other factors, limited flexibility, removed from customers.

3) Cost plus

- Basing your pricing on cost of production & your desired profit margin.

4) Dynamic

- Tailoring the prices of products for specific customer preferences.

Cost plus pricing

- Cost plus pricing is a pricing strategy by which the selling price of a product is determined by adding a specific fixed percentage to the products unit cost.
- Essentially the markup percentage is a method of generating a particular desired rate of return.
- Often being used for government contracts & has been criticized for reducing incentive for suppliers to control direct costs, indirect costs & fixed costs whether related to the production and sale of the product or service or not.

- The three parts of computing, the selling price are computing the total cost, computing the unit cost, and then adding a markup to generate the selling price.

Total → unit cost → Mark up → Selling price.

Product cost

Total cost = fixed cost + variable costs.

unit cost = total cost / no. of units

Markup price = unit cost * mark up percentage.

Selling price = unit cost + markup price.

Q) A Shop selling a Vacuum Cleaner will be examined since retail stores generally adopt this strategy.

Total cost = $450

Markup % = 12 %

Markup price = unit cost * markup %.

Markup price = $450 * 0.12

Markup price = $54

SP = unit cost + markup price.

SP = $ 450 + $ 54

SP = $ 504

Target return pricing.

- A producer rationally decides the minimum rate of return that the product must earn.
- The margin is decided on the basis of target rate of return, determined on the company's experience, consumer's paying capacity, risk involved, and similar other factors.

Penetration Pricing.

Is a marketing strategy used by businesses to attract customers to a new product or service by offering a lower price during its initial offering.

Predatory pricing.

It is a method of pricing in which a seller sets a price so low that other suppliers cannot compete and are forced to exit the market.

- The aim is that existing or potential competitors within the industry will be forced to leave the market, as they are unable to effectively compete with the dominant firm without making a loss.
- Once competition has been eliminated, the dominant firm now having a majority share of the market can raise its

prices to monopoly levels in the long term to recoup its losses.

Going Rate Pricing.

- Is when a business sets the price of its products or services based on the market price.
- This pricing strategy is often used to price similar products like commodities or generic items, that have little variation in design & function.

Advantages

1) Competitors price is taken as base.
2) Uniform price in market.
3) Misguiding customers is protected.

Disadvantages

1) Only competitors price is considered.
2) Inaccurate decisions
3) Production costs etc are ignored.

- Is popular in monopolistic and oligopoly markets where product differentiation is minimal or only cosmetic and consumers switching cost is almost negligible. It is mostly adopted when the product has reached maturity and has become generic to the extent that consumers ask for a good soap or soft tooth brush instead of a particular brand.

Price Skimming.

- Producers know that there is a segment of consumers who have deep pockets and who would like to be among the first few proud possessors of the latest product.

- These consumers have very low price elasicity of demand and are mostly governed by the status symbol factor and not by the intrinsic value of the product.

- Hence producers a very high price in the beginning to skim the market & earn super margins on scale