UNIT IV

Introduction to Markets

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Introduction:

Market is a place where buyer and seller meet, goods and services are offered for the sale and transfer of ownership occurs. A market may be also defined as the demand made by a certain group of potential buyers for a good or service. The former one is a narrow concept and later one, a broader concept. Economists describe a market as a collection of buyers and sellers who transact over a particular product or product class (the housing market, the clothing market, the grain market etc.). For business purpose we define a market as people or organizations with wants (needs) to satisfy, money to spend, and the willingness to spend it. Broadly, market represents the structure and nature of buyers and sellers for a commodity/service and the process by which the price of the commodity or service is established. In this sense, we are referring to the structure of competition and the process of price determination for a commodity or service. The determination of price for a commodity or service depends upon the structure of the market for that commodity or service (i.e., competitive structure of the market). Hence the understanding on the market structure and the nature of competition are a pre-requisite in price determination.

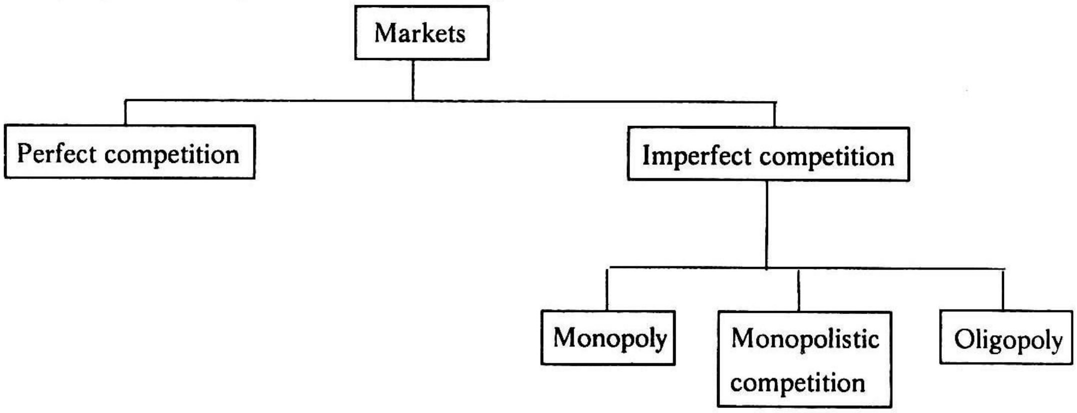
Market Structure:

Market structure refers to the characteristics of a market that influences the behavior and performance of firms that sell in that market:

The structure of market is based on the following features:

- The degree of seller concentration: this refers to the number of sellers and their market share for a given product or service in the market
- The degree of buyer concentration: this refers to the number of buyers and their extent of purchases of a given product or services in the market
- The degree of product differentiation: this refers to the extent by which the product of each trader is differentiated from that of the other.
- The conditions of entry into the market: more often there could be certain restrictions to enter into or exit from the market. The degree of ease with which one can enter or exit from the market also determines the market structure.

Below figure represents types of competition exists in the markets:



Perfect Competition:

Perfect competition refers to a market structure where competition among the sellers and buyers prevails in its most perfect form. In a perfectly competitive market, a single market price prevails for the commodity, which is determined by the forces of total demand and total supply in the market.

A market structure in which all firms in an industry are price takers and in which there is freedom of entry into and exit from the industry is called perfect competition. The market with perfect competition conditions is known as perfect market.

Features of Perfect Competition:

1. A large number of buyers and sellers: The number of buyers and sellers is large and the share of each one of them in the market is so small that none has any influence on the market price.
   There should be significantly large number of buyers and sellers in the market. The number should be so large that it should not make any difference in terms of price of quantity supplied even if one enters the market or one leaves the market.

2. Homogenous products or services: the products and services of each seller should be homogeneous. They cannot be differentiated from that of one another. It makes no difference to the buyer whether he buys from firm X or firm Z. in other words, the buyer does not have any particular preference to buy the goods from a particular trader or supplier. The price is one and the same in every firm. There are no concessions or discounts.

3. Freedom to enter or exit the market: there should not be restrictions on the part of the buyers and sellers to enter the market or leave the market. There should not be any barriers. The buyers can enter the market or leave the market whenever they want.

4. Prefect information available to the buyers and sellers: each buyer and seller has total knowledge of the prices prevailing in the market at every given point of time, quantity

supplied, costs, demand, nature of product, and other relevant information. There is no need for any advertisement expenditure as the buyers and sellers are fully informed.

5. Perfect mobility of factors of production: there should not be any restrictions on the utilization of factors of production such as land , labour, capital and so on. In words, the firm or buyer should have free access to the factors of production. Whenever capital or labor is required, it should instantly be made available.

6. Each firm is a price taker: an individual firm can alter its rate of production or sales without significantly affecting the market price of the product, a firm in a perfect market cannot influence the market through its own individual actions. It has no alternative other than selling its products at the price prevailing in the market. It cannot sell as much as it wants at its own set price.

Monopoly:

The word monopoly is made up of two syllables, Mono and poly. Mono means single while poly implies selling. Thus monopoly is a form of market organization in which there is only one seller of the commodity. There are no close substitutes for the commodity sold by the seller. Pure monopoly is a market situation in which a single firm sells a product for which there is no good substitute.

Features of monopoly

1. Single person or a firm: A single person or a firm controls the total supply of the commodity. There will be no competition for monopoly firm. The monopolist firm is the only firm in the whole industry.

2. No close substitute: The goods sold by the monopolist shall not have closely competition substitutes. Even if price of monopoly product increase people will not go in far substitute. For example: If the price of electric bulb increase slightly, consumer will not go in for kerosene lamp.

3. Large number of Buyers: Under monopoly, there may be a large number of buyers in the market who compete among themselves.

4. Price Maker: Since the monopolist controls the whole supply of a commodity, he is a price-maker, and then he can alter the price.

5. Supply and Price: The monopolist can fix either the supply or the price. He cannot fix both. If he charges a very high price, he can sell a small amount. If he wants to sell more, he has to charge a low price. He cannot sell as much as he wishes for any price he pleases.

6. Downward Sloping Demand Curve: The demand curve (average revenue curve) of monopolist slopes downward from left to right. It means that he can sell more only by lowering price.

Monopolistic competition

Monopolistic competition is said to exist when there are many firms and each one produces such goods and services that are close substitutes to each other. They are similar but not identical. Product differentiation is the essential feature of monopolistic. Products can be differentiated by means of unique facilities, advertising, brand loyalty, packaging, pricing, terms of credit, superior maintenance services, convenient location and so on.

Features of Monopolistic

1. Existence of Many firms: Industry consists of a large number of sellers, each one of whom does not feel dependent upon others. Every firm acts independently without bothering about the reactions of its rivals. The size is so large that an individual firm has only a relatively small part in the total market, so that each firm has very limited control over the price of the product. As the number is relatively large it is difficult for these firms to determine its price- output policies without considering the possible reactions of the rival forms. A monopolistically competitive firm follows an independent price policy.

2. Product Differentiation: Product differentiation means that products are different in some ways, but not altogether so. The products are not identical but the same time they will not be entirely different from each other. IT really means that there are various monopolist firms competing with each other. An example of monopolistic competition and product differentiation is the toothpaste produced by various firms. The product of each firm is different from that of its rivals in one or more respects. Different toothpastes like Colgate, Close-up, Forehans, Cibaca, etc., provide an example of monopolistic competition. These products are relatively close substitute for each other but not perfect substitutes. Consumers have definite preferences for the particular verities or brands of products offered for sale by various sellers. Advertisement, packing, trademarks, brand names etc. help differentiation of products even if they are physically identical.

3. Large Number of Buyers: There are large number buyers in the market. But the buyers have their own brand preferences. So the sellers are able to exercise a certain degree of monopoly over them. Each seller has to plan various incentive schemes to retain the customers who patronize his products.

4. Free Entry and Exist of Firms: As in the perfect competition, in the monopolistic competition too, there is freedom of entry and exit. That is, there is no barrier as found under monopoly.

5. Selling costs: Since the products are close substitute much effort is needed to retain the existing consumers and to create new demand. So each firm has to spend a lot on selling cost, which includes cost on advertising and other sale promotion activities.

6. Imperfect Knowledge: Imperfect knowledge about the product leads to monopolistic competition. If the buyers are fully aware of the quality of the product they cannot be influenced much by advertisement or other sales promotion techniques. But in the business world we can see that thought the quality of certain products is the same, effective advertisement and sales promotion techniques make certain brands monopolistic. For examples, effective dealer service backed by advertisement-helped popularization of some brands through the quality of almost all the cement available in the market remains the same.

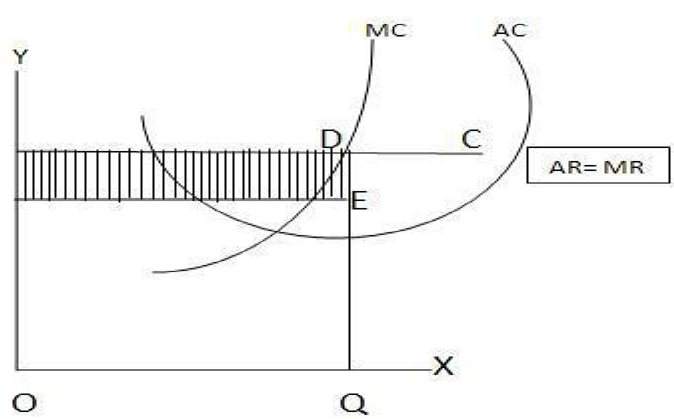
7. The Group: Under perfect competition the term industry refers to all collection of firms producing a homogenous product. But under monopolistic competition the products of various firms are not identical through they are close substitutes. Prof. Chamberlin called the collection of firms producing close subset

PRICE OUTPUT DETERMINATION INCASE OF PERFECT COMPETITION

Short Run

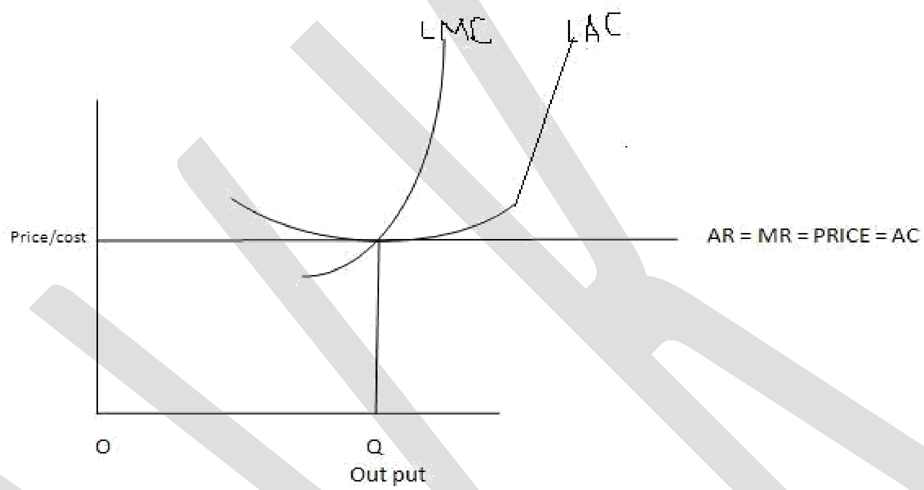
The price and output of the firm are determined, under perfect competition, based on the industry price and its own costs. The industry price has greater say in this process because the firm own sales are very small and insignificant. The process of price output determination in case of perfect competition.

The firm demand curve is horizontal at the price determined in the industry (MR = AR = price). This demand curve is also known as average revenue curve. This is because if all the units are sold at the same price, on an average , the revenue to the firm equal its price.



Long Run

Having been attracted by supernormal profits, more and more firms enter the industry. With the result, there will be a scramble for scarce inputs among the competing firms pushing the input prices. Hence, the average cost increases. The entry of more and more firms will expand the supply pulling down the market price. The entry of the firms into the industry continues till the supernormal profit is completely eroded. In the long run, the firms will be in the position to enjoy only normal profits but not supernormal profit. Normal profits are the profit that is just sufficient for the firms to stay in the business.



PRICE OUT PUT DETERMINATION IN MONOPOLY

Under monopoly the average revenue curve for a firm is a downward sloping one. It is because, of the monopolist reduces the price of his product, the quantity demanded increase and vice versa. In monopoly, marginal revenue is less than the average revenue.

The monopolist always wants to maximize his profits. To achieve maximum profits, it is necessary that the marginal revenue should be more than the marginal cost.