Quick View

Market

A market is any one of variety of systems, institutions, procedures, social relations and infrastructures whereby businesses sell their goods, services and labour to people in exchange for money. Goods and services are sold using a legal tender such as fiat money. This activity forms part of the economy. It is an arrangement that allows buyers and sellers to exchange items.

FEATURES OF PERFECT COMPETITION

Introduction

Perfect competition is a state of a market. Anything which facilitates contact between buyers and sellers constitutes a market. It may be a face to face meeting at some place or simply verbal negotiations through telephone, internet, etc.

Conventionally, in microeconomics the markets are classified into these states: perfect competition, monopoly, monopolistic competition and oligopoly. There are many criteria of classification, the number of sellers, similarity of products, availability of information, mobility of firms and the inputs engaged in the firm, etc. Whatever the criteria the end result is reflected in one thing:

How much influence an individual seller, on his own, is able to exercise on the market. Lower the influence more the competitive nature of the market it indicates. If the influence of an individual seller is zero, or virtually zero, the market is said to be perfectly competitive.

Meaning

Perfect competition can be defined either in terms of its characteristic features, or in terms of the unique end result of these characteristics. Unique in the sense that it is specific to a perfectly competitive market. In terms of its features, a perfectly competitive is a market where there is large number of buyers and sellers, the firms produce homogeneous products, the buyers and sellers have perfect knowledge and the firm is free to entry or makes an exit in and out of industry. In terms of the end result of these features which is unique to this market, a perfectly competitive market is one in which an individual firm cannot influence the prevailing market price of the product on its own.

Features and their implications

A perfectly competitive market has the following features:

1. Large number of sellers and buyers

Note that 'large number' is not a specifically defined number. However, it has a specific implication. Let us talk about the large number of sellers first. The words 'large number' imply that the number of sellers is large enough to render a single seller's share in total market supply of the product insignificant. It has a further implication. Insignificant share means that if only one individual firm reduces or raises its own supply, the prevailing market price remains unaffected. The prevailing market price is the one which was set through the interaction of market demand and market supply forces, for which all the sellers and all the buyers together are responsible. One single seller has no option but to sell what it produces at this market determined price. This position of an individual firm in the total market is referred to as **price taker.** This is a unique feature of a perfectly competitive market.

Similarly, the 'large number' of buyers also has the same implication. A single buyer's share in total market demand is so insignificant that the buyer cannot influence the market price on his own by changing his demand. This makes a single buyer also a price taker.

To sum up, the feature 'large number' indicates ineffectiveness of a single seller or a single buyer in influencing the prevailing market price on its own, rendering him simply a price taker.

2. The products of all the firms in the industry are homogenous

It means that the buyers treat the products of all the firms in the industry as homogenous. The products produced by the firms are identical, or treated as identical, or perfectly standardized. The buyers do not distinguish the output of one firm from that of the other. The implication of this feature is that since the buyers treat the products as identical they are not ready to pay a different price for the product of any one firm. They will pay the same price for the products of all the firms in the industry. On the other hand, any attempt by a firm to sell its product at a higher price will fail.

To sum up, the 'homogenous products' feature ensures a uniform price for the products of all the firms in the industry.

3. Perfect knowledge about markets for outputs and inputs.

The firms have all the knowledge about the product market and the input markets. Buyers also have perfect knowledge about the product market. Let us take the product market first. The implication of perfect knowledge about the product market is that any attempt by any firm to charge a price higher than the prevailing uniform price will fail. The buyers will not pay because they have perfect knowledge. There is no ignorance factor operating in the market. The sellers do not charge a lower price due to ignorance. The buyers do not pay a higher price due to ignorance. A uniform price prevails in the market. As regards the knowledge about the input markets, the implicit assumption is that each firm has an equal access to the technology and the inputs used in the technology. No firm has any cost advantage. Cost structure of each firm is the same. All the firms have a uniform cost structure. Since there is uniform price and uniform cost in case of all firms, and since profits equals cost less price, all the firms earn uniform profits.

4. Freedom to firms to enter or to leave the industry in the long run

Freedom of entry means that there are no artificial barriers and natural barriers in the way of a new firm wishing to enter into industry. The artificial barriers may take the form of patent rights, legal restrictions, etc. The natural barrier may take the form of huge capital expenditure required to start a new firm, which the firm wishing to enter is not able to arrange. Freedom of

exit means no barriers in the way of a firm deciding to leave the industry. Government rules, labour laws, loss of huge fixed capital etc. do not come in the way. The freedom of entry and exit of firms has an important implication. This ensures that no firm can earn above normal profits in the long run. Each firm earns just the normal profits, i.e. minimum necessary to carry on business. In Microeconomics, normal profits is treated as an opportunity cost, and therefore, counted in calculation of total cost. Since profit equals total revenue minus total cost, normal profit means zero economic profit. Why? Let us explain.
Suppose the existing firms are earning above normal profits, i.e. positive economic profits. Attracted by the positive profits, the new firms enter the industry. The industry's output, i.e. market supply, goes up. The price comes down. New firms continue to enter and the price continues to fall till economic profits are reduced to zero. Now suppose the existing firms are incurring losses. The firms start leaving. The industry's output starts falling, price starts going up, and all this continues till losses are wiped out. The remaining firms in the industry then once again earn just the normal profits. Only zero economic profit in the long run is the basic outcome of a perfectly competitive market.

MONOPOLY

MEANING

A situation in which a single company owns all or nearly all of the market for a given type of product or service. This would happen in the case that there is a barrier to entry into the industry that allows the single company to operate without competition(for example, vast economies of scale, barriers to entry, or governmental regulation). In such an industry structure, the producer will often produce a volume that is less than the amount which would maximize social welfare.

FEATURES

1. A single seller has complete control over the supply of the commodity.
2. There are no close substitutes for the product.
3. There is no free entry and exit because of some restrictions.
4. There is a complete negation of competition.
5. Monopolist is a price maker.
6. Since there is a single firm, the firm and industry are one and same i.e. firm coincides the industry.
7. Monopoly firm faces downward sloping demand curve. It means he can sell more at lower price and vice versa. Therefore, elasticity of demand factor is very important for him.

OLIGOPOLY

MEANING

Oligopoly is a market situation in which an industry has only a few firms (or few large firms producing most of its output) mutually dependent for taking decisions about price and output.

The two features of this definition – few firms and interdependence between firms – are explained in a section below.

TYPES

If in an oligopoly market, the firms produce homogeneous products, it is called perfect oligopoly. If the firms produce differentiated products, it is called imperfect oligopoly. If in an oligopoly market, the firms compete with each other, it is called a non-collusive or non cooperative, oligopoly. If the firms cooperate with each other in determining price or output or both, it is called collusive oligopoly, or cooperative oligopoly. When there are only two firms producing a product, it is called duopoly. It is a special case of oligopoly.

FEATURES

(1) Few firms

Few firms mean either only a few firms in number or a few big firms producing most of the output of the industry. The exact number of firms is not defined. The word 'few' signifies that the number of firms is manageable enough to make a guess of the likely reactions of rival by a firm.

(2) Firms are interdependent in taking price and output decisions.

When there are only a limited number of firms, it is likely that rivals have some knowledge as to how these firms operate. It one firm does something about the price and quantity of the product it produces, the rivals are likely to take quick note of it and react by changing their own price and output plans. Therefore the given firm, expecting reactions from its rivals, takes into account such possible reactions before taking any decision about the price and output of the product it produces. It makes each firm dependent on other firms in the industry.

(3) Barriers to the entry of firms.

The main reason why the number of firms is small is that there are barriers which prevent entry of firms into industry. Patents, large capital, control over the crucial raw materials etc, prevent new firms from entering into industry. Only those who are able to cross these barriers are able to enter.

(4) Non-price competition

Firms try to avoid price competition for the fear of price war. They use other methods like advertising, better services to customers, etc to compete with each other.

MONOPOLISTIC COMPETITION

This market structure contains elements of both monopoly and perfect competition. In 1933 at Harvard University, Edward Chamberlin published *The Theory of Monopolistic Competition*. He used the term to describe a market in which many producers offer products that are close substitutes but are not viewed as identical by consumers. Each supplier has some power over the price it can charge. Thus, the firms that populate this market are not price takers, as they would be under perfect competition, but are price makers.

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1) Product Differentiation

In monopolistic competition, the product differs among sellers. Sellers differentiate their products in four basic ways:

a) Physical differences
b) Location
c) Services
d) Product Image

2) Free Entry and Exit

It is relatively easy for new firms to enter the market with their own brands and for existing firms to leave if their products become unprofitable.

EQUILIBRIUM PRICE UNDER PERFECT COMPETITION

Meaning of equilibrium

Equilibrium, in general terms. implies (a) a balance between the opposite forces and (b) a state of rest or a situation that has a tendency to persist. Let us take examples to show the application of these meanings in microeconomics.
Let us take a market situation in which buyers and sellers are negotiating to buy and sell a good. Both have different prices to offer. But the good will be sold only when both agree to a common price and a common quantity at that price. If both agree, a market equilibrium is said to emerge. Note that buyers and sellers have opposite interests. The buyers will like to pay as low a price as possible. The sellers will like to charge as high a price as possible. Agreement on a common price and quantity creates a balance between the two opposite interests. This equilibrium price and quantity has a tendency to persist.

Equilibrium price

Equilibrium price is the price at which the sellers of a good are willing to sell the same quantity which buyers of that good are willing to buy. We can explain this meaning with the help of market demand and supply schedule of a good, given below:
Refer to the schedule. The market equilibrium is established at a price of Rs. 3 per unit,
because at this price both the market demand and market supply are equal. This is the price which has a tendency to persist.

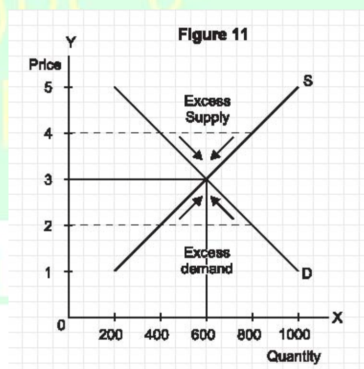
Why is not any other price an equilibrium price?

Take, for example, a price less than the equilibrium price. Suppose it is Rs. 2 per unit. At this price market demand is greater than market supply. It is called an excess demand situation. But this price cannot persist. It will change. Why?

It is because the buyers will not be able to buy all what they want to buy. The pressure of excess demand will push the market price up. This will have two effects. Supply will go up because the producers are willing to supply more at a higher price. Demand will go down because the buyers are willing to buy less at a higher price. In fact, this is what is required to restore equilibrium. The tendency of supply going up and demand going down will continue till market supply becomes equal to market supply once again and the excess demand becomes zero. This is achieved at Rs. 3 per
unit. The equilibrium is restored.
Let us now take a price higher than the equilibrium price. Suppose it is Rs. 4 per unit. At this price now the market supply is greater than market demand. It is called an excess supply situation. Even this price cannot persist. It is because the sellers will not be able to sell all what they want to sell. The excess supply pressure will push the price downwards. This will have two effects. Supply will go down and demand will go up. The tendency
will continue till market demand becomes equal to market supply
once again, and the price settles at Rs. 3 per unit.
To sum up, the equilibrium price is the price at which market demand equals market supply. This price has a tendency to persist. If at a price the market demand is not equal to market supply there will be either excess demand or excess supply and the price will have tendency to change until it settles once again at a point where market demand equals market supply.

Graphic Presentation

The equilibrium is at E the intersection of supply and demand curves representing the two schedules given above. The equilibrium price is Rs. 3 and equilibrium quantity 600 units. The price higher than Rs. 3, creates excess supply and ultimately returns to Rs. 3 on account of the effects explained above. The arrows indicate the tendencies. The price below the equilibrium price creates excess demand and has a tendency to return to Rs. 3 per unit on account of the effects explained above and indicated by the arrows.



Can the equilibrium price change?

Yes, when demand or supply or both increase or decrease. 'Increase', as you know, means rise in demand or supply due to factors other than the own price of the good. Similarly the term 'decrease' is defined. Graphically, it means shift of demand curve, or supply curve or both. You are familiar with these terms. You are expected to study the chain effects of shifts in demand and supply on equilibrium price and quantity.

Average Revenue and marginal revenue curves of a perfectly competitive firm

The forces of market supply (i.e. supply by industry) and market demand (demand by all the buyers) determine the market price. The firm, being a price taker, adopts this price and is free to sell any quantity it likes at this price. The price taker feature determines the shape of the firms AR and MR curves. Refer to the figure -12 b.

The figure 12a shows the intersection of demand and supply curves at E determining the price OP. The figure 12b shows the adoption of price by the price taker firms who are free to sell any quantity, at this price. This makes the AR curve perfectly elastic and thus parallel to the X-axis. As per the average marginal relationship, when AR is constant, MR must be equal to AR. Therefore, AR curve is also the MR curve of the firm.