10 FORMS OF MARKET AND PRICE DETERMINATION

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MEANING OF MARKET

In general, the word 'market' refers to a place or an area where buyers and sellers generally meet so as to buy and sell a particular commodity. In Economics, we make use of the term 'market' in a different sense. It refers to a particular commodity that is sold and purchased rather than a place or an area. For example, cotton market, tea market etc. Any effective arrangement for bringing buyers and sellers into contact with one another is defined as a market in economics. The essentials of a market are the following:

1. Market does not confine to a particular place but the whole area wherein buyers and sellers of a commodity are spread over;
2. There must be buyers and sellers and for that physical presence is not necessary. In modern days, we sell goods through websites or electronic shopping markets or through telephonic media;
3. There must be a commodity which is bought and sold; and
4. There should be free interaction between buyers and sellers so that only one price is agreed upon for the commodity.

FORMS OF MARKET

Economists have classified markets on the basis of:

(a) the number of buyers and sellers of the commodity;
(b) the nature of the commodity produced by the sellers;
(c) degree of freedom in the movement of goods and factors; and
(d) whether knowledge on the part of the buyers and sellers regarding prices in the market is perfect or imperfect.

On the basis of these criteria, economists have distinguished between four basic forms of the market:

1. Perfect competition
2. Monopoly

Ref – Intro to Economics, By *Dutta*, New Age Pub

3. Monopolistic competition
4. Oligopoly

These market forms are discussed as under.

PERFECT COMPETITION

A market is said to be perfect when there is a large number of buyers and sellers of the product and there is a complete absence of rivalry among the firms. The firms sell products which are homogeneous.

Features of Perfect Competition

The important features of this type of market are summarized as follows:

(1) **Large number of buyers and sellers.** The number of buyers and sellers is so large that no individual buyer or seller can influence the market price and output by his independent action. The reason for this is that every buyer and seller purchases or sells a very insignificant amount of the total output.

(2) **Homogeneous products.** A firm produces a product which is accepted by customers as homogeneous or identical. There is no way in which a buyer can distinguish products sold by different sellers. The assumptions of large numbers of sellers and buyers and of product being homogeneous indicate that a single firm is a price-taker. Demand curve or average revenue curve is infinitely elastic, i.e., demand curve is horizontal straight line parallel to output axis. Therefore, a firm under perfect competition sells any amount of output at the prevailing market price.

(3) **Free entry and exit of the firms.** Every firm is free to join or leave the industry. If the industry is making profits new firms can enter the market to share these profits. Similarly, if the industry suffers losses the individual firms can quit the market.

(4) **No government regulation.** There is no government interference in the market in the form of taxes, subsidies, rationing of essential goods etc.

(5) **Uniform price.** At a particular time uniform price of a commodity prevails all over the market.

The above five conditions are related to pure competition. Perfect competition requires the following additional assumptions/conditions to be fulfilled.

(6) **Perfect knowledge of market conditions.** Buyers and sellers have full knowledge of the price at which transactions take place in the market.

(7) **Perfect mobility of the factors.** Factors of production can freely move from one firm to another in the industry. They can also move from one job to another and in this way there is a scope for learning newer skills.

(8) **Absence of selling and transportation costs.** Selling and other promotional costs are not present in perfect market.

PRICE AND OUTPUT DETERMINATION UNDER PERFECT COMPETITION

Equilibrium price under perfect competition is determined not by the seller/firm but by the industry (all firms together). The price determined by the industry is accepted by all firms. Thus, individual seller/firm is a price taker under perfect market. This is explained with the help of diagrams below:

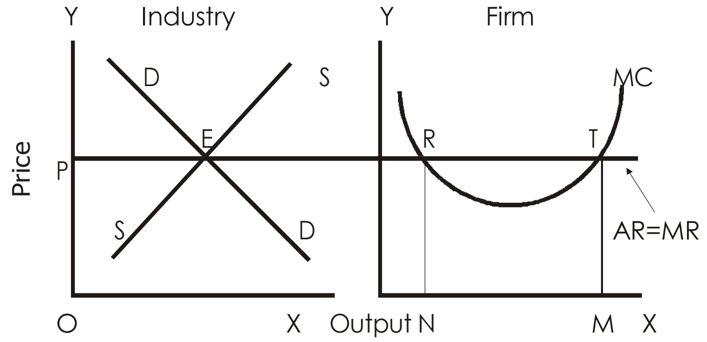

Fig. 32

In the diagram (Industry), DD and SS are the demand and supply curve respectively. The equality point of SS and DD is E, which is the equilibrium point. At this point, price OP is determined. OP price will be accepted by all firms in the perfect market and sell any amount of good at this price. Hence, average revenue curve faced by an individual firm is horizontal straight line parallel to the x-axis or perfectly elastic. Now, the firm’s task is to determine equilibrium output.

It is to be remembered that any seller will sell or produce that level of output where its profit is maximized. And profit is maximized where the following two conditions are satisfied:

1. MR = MC
2. MC curve cuts MR from below.

In the second diagram (Firm), it is seen that there are two equilibrium points-R and T, because at these points the first condition is met. However, point T satisfies both conditions. Hence the firm will be in equilibrium at point T and produce OM level of output at OP price. The firm will not stop producing at point R because beyond this point AR > MC and therefore, there is still enough scope to earn profits and maximize it. Similarly any output level greater than OM will bring losses to the firm as MC > AR (=MR) beyond point T.

In the short run, there are three possibilities for a firm. These are – (a) when a firm makes abnormal profits (AR > AC); (b) when it earns only normal profit (AR = AC); and (c) when it incurs losses, but does not shut down. Firms will operate till they are able to get variable costs. They will shut down their business when they cannot earn even average variable costs of production.

MONOPOLY

The word ‘Monopoly’ has been derived from the two Greek words, ‘Monos’ which means single, and ‘polus’ which means a seller, Monopoly is a market situation where there is single seller of

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a product and he has full control over the supply of that commodity. He produces such a product which has no close substitutes.

Thus monopoly market has the following features:

1. There is a single seller of the product.
2. There are no close substitutes of the commodity produced by monopoly seller.
3. There is restriction on entry or exit of other firms.
4. There is no distinction between a firm and an industry under monopoly.
5. Seller is a price maker.
6. A monopoly firm earns abnormal profits both in short and long run.
7. Selling costs are negligible.
8. A monopolist is capable of following price discrimination, which means it can charge different prices for its products from different buyers.

Let us now see what the causes of monopoly are:

1. Monopoly can be the result of exclusive ownership of important raw materials or knowledge of production techniques;
2. Patent rights acquired by a firm for its product;
3. Foreign trade barriers imposed by the government, which prevents any foreign company to enter the industry.
4. A price policy adopted by the existing firms which prevents new firms to enter.

MONOPOLISTIC COMPETITION

In a monopolistic competitive market the number of sellers is large but each seller has a product differentiated from those of his rivals. What one firm produces is not quite like what any other firm produces. In fact, each firm has a kind of limited monopoly of its own product and hence the name "monopolistic competition". The following are the main features of the monopolistic competitive market:

1. **Large number of firms:** The number of firms which constitutes an industry is fairly large.
2. **Product Differentiation:** Under monopolistic competition each firm produces a differentiated product. The form or the quality of a product can be differentiated by using different kinds of raw materials, through workmanship, colour, packing, design, durability, etc. For example, different firms produce soft drinks like coca cola, limca, sprite, thums up etc. Though the ingredients are same, products carry a different brand name.
3. **Free Entry and Exit:** Firms under monopolistic competition are free to enter and leave the industry at any time.
4. **Individual Pricing by a Firm:** In this type of market, every individual producer has his own independent price policy.

5. **Selling Costs:** Every firm tries to promote its sales through expenditure on advertisement and on other promotional activities such as sales men's incentives, gifts etc.
6. Under monopolistic competition, both price and non-price competition prevails.

OLIGOPOLY

Oligopoly is a market structure where there are only a few producers/sellers of a commodity (but more than two producers) competing with one another. "Few" means enough number of firms that can keep watch on the actions of rivals and behave accordingly. A firm cannot take independent action without thinking of in what way its opponent firms will react. Precisely, few may mean three or four or twenty or thirty firms, including some major players while others small producers. Automobile companies making two-wheelers (Bajaj, Hero Honda, Kinetic, Yamaha etc) or four-wheelers (Ambassadar, Maruti, Tata, Mahindra & Mahindra etc); TV manufacturers (BPL, Videocon, Onida, LG, Samsung, Sony etc) etc are the examples of oligopoly. Oligopoly is of two kinds:

Pure Oligopoly

It is a market where the products are homogenous. There is mutual interdependence between firms. Any change in price by one firm has a substantial effect on the sales of other and cause them to change their price. Examples of pure oligopoly are found in such industries as cement, coal, gas, steel, etc.

Differentiated Oligopoly

Under differentiated oligopoly, products are close substitutes for each other. Price change by one firm has less direct effect upon rival firms. Examples of differentiated oligopoly are refrigerators, television sets, air-conditioners, automobiles, scooters, motorbikes, instant coffee, etc.

Characteristics of Oligopoly

Some of the important features of oligopoly are as follows:

1. **Interdependence:** Under oligopoly, a firm cannot take independent price and output decision. As the number of competing firms is limited, therefore, each firm has to take into account the reactions of the rival firms. Price and output decisions of one oligopoly firm has considerable effect on the price and output decision of the rival firms.
2. **Indeterminate Demand Curve:** An oligopoly firm can never predict sales correctly. It can never be certain about the nature and position of its demand curve. Any change in price or output by one firm leads to a series of reactions by the rival firms. As a result, the demand curve of the oligopoly firm remains indeterminate (indefinite and shifting). Thus, under oligopoly a price, once determined, continues to prevail for a long time. According to Paul M. Sweezy, an oligopolistic firm faces a kinked demand curve at the existing price as shown under in the figure. If a firm reduces prices of its products, other firms will also follow as demand curve is highly inelastic in its lower part EB. As a result, the firm which has lowered the price will not gain anything out of it act. Now, if it raises its price above the prevailing price OP, other firms will not follow this time as demand curve above the prevailing price (upper part) AE is more elastic.

Thus, the firm will lose due to his action. Therefore, price will remain more or less stable under oligopoly situation. The demand curve in the Fig. 10.1 is kinked (bent) at E.

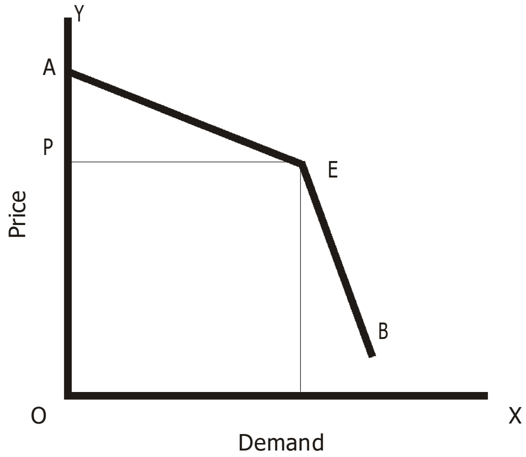

Fig. 10.1

3. **Role of selling costs:** Advertisement, publicity and other sales techniques play an important role in oligopoly pricing. Oligopoly firm employs various techniques of sales promotion to attract large number of buyers and maximize the profits. Selling cost has a direct bearing on the sales of the oligopoly firm.
4. **Price Rigidity:** Oligopoly firm generally sticks to a price, which is determined after a lot of planning and negotiations, with the competing firms. A firm will not resort to price cut, as it would lead to retaliatory actions by the rival firms resulting in price war. An oligopoly firm will also not raise the price because the rival may not follow suit and, as a result, the firm will lose many of its customers.
5. **Group Behaviour:** Price and output decisions of one oligopoly firm have direct effect on the competing firms. Interdependence of the firms compels them to think in terms of mutual co-operation. Firms try to maximize their profits through collusive action. Instead of independent price output strategy oligopoly firms prefer group decisions that will protect the interest of all the firms.

DUOPOLY

Duopoly is a market situation where there are only two sellers. Duopoly can be with or without product differentiation. The important feature of duopoly is that the individual firm has to carefully consider the indirect effects of its own decision to change its price or output or both.

Questions for Review

1. What is meant by market in economics?
2. What type of demand curve does a firm have under perfect competition?
3. Explain the characteristics of monopolistic competition. Compare demand curves under monopolistic competition and monopoly.