15. Oligopoly

Oligopoly is a type of market structure where a **small number of large firms** supply similar products in an industry

CHARACTERISTICS

Many big similar firms provide industry output but each is aware that **any action on price will provoke a rival to react**

Many **close substitutes** are available but market is tightly coordinated (with interdependent firms)

ASSUMPTIONS

Dominated Market

- **Few large suppliers** in the industry who have power to influence the selling price
- Industry is '**clustered**' with high concentration ratio (output is concentrated in a handful of big firms)

Objectives

Other than max profits

Price Competition

- Firms reluctant to engage in price competition – want to avoid a price war
- Instead – they engage in **non price competition** i.e. free gifts, promotions, coupons or sponsorship

Product Differentiation

Huge amounts spent on advertising to distinguish products

Barriers to Entry

Exist

Collusion

2+ Firms can collude to restrict competition to increase joint profit

Sticky Prices

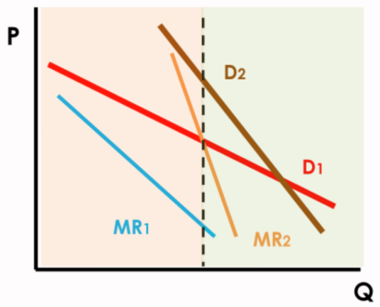
Cyclical periods of price stability and intense price competition

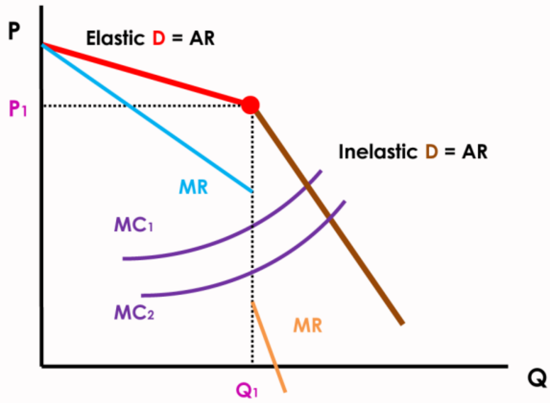
Firms Interdependent

Each decision is 'reaction based' on what rivals may do

The Kinked Demand Curve

Remember, it's a tale of two halves





Firms will always aim to keep **profits high** and keep their position in the market (**market share**)

- A firm can *only* do two things: ↓ *or* ↑P
- Either rivals follow the firm **(after ↓P)** *or* don't **(after ↑P)**
- These two reactions suggest two distinctively different demand (*and* therefore **MR**) curves

D_1 (MR_1 is twice as steep as D_1)
D_2 (MR_2 is twice as steep as D_2)

Increase in Price If a firm ↑P (>P_1), it will lose a disproportionate share of the market (customers will switch to rival similar products). An **elastic** demand curve **(AR)** exists **(>P_1)**

Decrease in Price If a firm ↓P (<P_1), it wont gain many customers – its rivals will likely follow and lower prices (causing a price war). An **inelastic** demand curve (AR) exists (<P_1)

So a firm likely wont change its price (price stability)

Why are prices so stable? A firms **marginal cost (MC)** can change and not cause the firm to have to change its price (as MR is still equal to MC) – thanks to the vertical MR curve (unique to oligopoly)

ASSUMPTIONS (Continued)

Barriers to Entry

- High **start up costs**
- **Brand proliferation** (several brands advertised and controlled by one large company)
- **Economies of scale** (EOS) in advertising
- **Cost advantages** of existing firms (EOSs, well trained workforce, customer good will/loyalty or patents)

Price Competition

(and Price Leadership)

- **Price Leader:** One firm in dominant position because of large size or early market entry
- This leader may set its prices independently of others in the industry (but a price increase can cause a price war – self defeating)

Collusion

Any action taken by separate and rival companies to restrict competition between them (and increase profits)

2 Types

Explicit Collusion

Separate companies jointly decide to collude

(i.e. via a cartel)

- **Fixed price** applies to all firms
- **Refusal to supply/buy** to/from retailers not in the cartel
- **Quota system which limits products to certain agreed amounts** (to keep price as high as possible)

Implicit (Tacit) Collusion

No formal agreement between firms but each firm recognises that joint profits will be higher if firms behave as monopolists (i.e. OPEC)

- **(Quasi) Fixed price** a firm will not provoke its rivals into a price war
- **Joint policy of profit maximisation** each firm can set MC=MR
- **Conflicting aims** (a) maximise profits (b) cooperate with competitors

Objectives (other than profit maximisation)

Avoid Gov Interference

High profits attract suspicion/ regulation government will impose restrictions to encourage more competition/ tackle monopoly power

Will opt for lower output

Keep Market Position

High profits attract new entrants (and potential price wars) causing loss of sales. Firm will engage in **'limit pricing' (a certain price level to limit profits).** Potential firms discouraged from entering

Satisfaction

Small family business will be happy with a certain profit to have a good standard of living. Don't want the stress and added workload of higher output

Fixed Salary

Companies where managers are **not shareholders** (semi-state public companies) do not aim to max profit. They aim to provide a public service (i.e. bus service or postal service) – salary of these managers **fixed** regardless of profit

Baumol's Theory

'Inverse U' Shaped Graph

Once an **established minimum level of profit** reached – firm focuses on other objectives (not concerned with maximising sales, profit or revenue – at the peak of the 'inverse U' curve)