

Chapter 11: The Principles of Market Forces

Key Revision Points

Introduction to the competitive environment

Economists define markets in terms of the interaction between two groups:

- Those seeking to buy products
- Those seeking to sell them

Economists distinguish between those economic influences that operate at the level of the individual firm and those that relate to the economy as a whole. The study of an organisation and its customers / suppliers in isolation from the rest of the economy is generally referred to as *microeconomic* analysis. In this type of analysis, the national economy is assumed to be stable.

Market structure

The term market structure is used to describe:

- The number of buyers and sellers operating in a market
- The extent to which the market is concentrated in the hands of a small number of buyers and/or sellers
- The degree of collusion or competition between buyers and/or sellers

Market structures range from the theoretical extremes of perfect competition and pure monopoly. In practice, examples of the extremes are rare.

Perfect Competition

This is the simplest type of market structure to understand. Although rarely found in practice, a sound understanding of the way they work is essential for understanding competitive market pressures in general.

Perfectly competitive markets are attributed with the following principal characteristics:

- There are a large number of producers.
- There are also a large number of buyers.
- Buyers and sellers are free to enter or leave the market.
- There is a ready supply of information.

Perfect competition implies that firms are price takers in that competitive market forces alone determine the price at which they can sell their products.

The most important reason for studying perfect competition is that it focuses attention on the basic building blocks of competition: demand, supply and price determination.

Demand

Demand is measured in terms of how many people are actually *able and willing* to buy a product at a given price and given a set of assumptions about the product and the

environment in which it is being offered. Demand is also expressed in terms of a specified time period, for example so many units per day.

A demand curve is based on a number of assumptions. For example, that the price of substitutes for cheese will not change or that consumers will not suddenly take a dislike to cheddar cheese.

Actually collecting information with which to plot a demand curve poses theoretical and practical problems. The main problem relates to the cross-sectional nature of a demand curve. However, this kind of information can often only be built up by a longitudinal study of the relationship between prices and volume over time.

Supply

Supply is defined as the amount of a product that producers are willing and able to make available to the market at a given price over a particular period of time.

It is important to distinguish movements along a supply curve from shifts to a new supply curve.

Price determination

It is possible to redraw the demand and supply lines on a single graph.

In perfectly competitive markets, the process of achieving equilibrium between supply and demand happens automatically without any external regulatory intervention.

It is important to remember that in a perfectly competitive market, individual firms are price takers. The market alone determines the 'going rate' for their product. Changes in the equilibrium market price come about for two principal reasons:

- Assumptions about suppliers' ability or willingness to supply change, resulting in a shift to a new supply curve
- Assumptions about buyers' ability or willingness to buy change, resulting in a shift to a new demand curve

New equilibrium prices and trade volumes can be found at the intersection of the supply and demand curves. In practice, both the supply and demand curves may be changing at the same time.

Elasticity of demand

Elasticity of demand refers to the extent to which demand changes in relation to a change in price or some other variable such as income.

Price elasticity of demand refers to the ratio of the percentage change in demand to the percentage change in price. Where demand is relatively unresponsive to price changes, demand is said to be inelastic with respect to price.

A number of factors influence the price elasticity of demand for a particular product. The most important is the availability of substitutes. The absolute value of a product and its importance to a buyer can also influence its elasticity.

For any measure of elasticity, it is important to consider the time period over which is being measured. In general, products are much more inelastic to changes in price over the short term.

Elasticity of supply

The concept of elasticity can also be applied to supply, so as to measure the responsiveness of supply to changes in price.

If suppliers are relatively unresponsive to an increase in the price of a product, the product is described as being inelastic with respect to price. If producers increase production substantially as prices rise, the product is said to be elastic. As with price elasticity of demand, time is crucial in determining the elasticity of supply.

Limitations of the theory of perfect competition

These are some of the more important reasons why perfect competition is rarely achieved in practice:

- Perfect competition only applies where production techniques are simple and opportunities for economies of scale are few.
- Markets are often dominated by large buyers who are able to exercise influence over the market.
- It can be naïve to assume that high prices and profits in a sector will attract new entrants, while losses will cause the least efficient to leave.
- A presumption of perfectly competitive markets is that buyers and sellers have complete information about market conditions. In fact, this is often far from the truth.