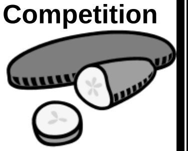
How Competitive Is the Industry?

Characteristics of Four Market Structures

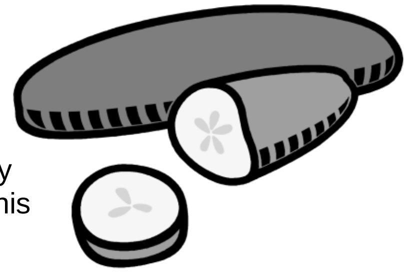
STEP 1: Summarize each of the markets in Google Sheets. Share with pclark@nwlsd.org
STEP 2: Fill in the table below, using the information that follows. Turn in packet.

Market Characteristics

	Number of Firms in Industry	Similar or Different Products	Ability to Control Prices	Ease of Entering the Industry	Existence of Non-Price Competition	Other Market Examples
Pure Competition 						
Monopolistic Competition 						
Oligopoly 						
Monopoly 						

How Competitive Is the Industry?

PURE COMPETITION AND CUCUMBERS



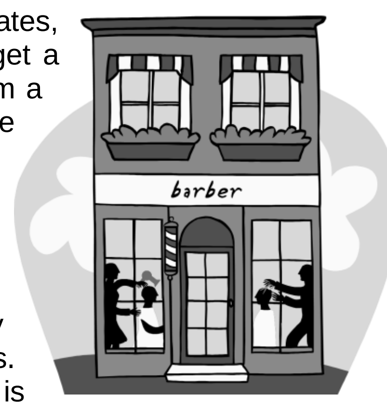
The U.S. agriculture industry comes close to approximating what economists mean when they talk about an industry in pure or perfect competition. There are many (more than two million) farms in the United States. Because this number is so high, it is unlikely that any one farmer could set, or influence, overall farm prices. To make this clearer, let's focus on a certain farm product: cucumbers.

Several states including Michigan, Mississippi, Ohio, Iowa, Florida, New York, Wisconsin, and Indiana list cucumbers among their major agricultural crops. In addition to those who grow cucumbers to sell to others, many people grow them in home gardens for their own use. It is relatively easy to begin growing cucumbers. They thrive in many types of soil and require temperatures of about 65-75 degrees Fahrenheit, commonly found throughout the United States in summer months. Cucumbers grow quickly; they are generally ready to harvest about two months from the time of planting.

Let's assume that you decide to enter the cucumber industry by growing cucumbers in your backyard to sell at a local farmers' market. Although there are different varieties of cucumbers, your cucumbers will most likely be very similar, if not identical, to others for sale in your area. If the going price at the farmers' market is, say, three cucumbers for a dollar, and you try to sell yours for a higher price, you probably won't sell any at all. If you decide to take your cucumbers off the market, the decrease in overall supply won't be enough to cause the going price to rise. You are unable to control the price because there are so many other producers. And it probably wouldn't be profitable for you to try to use non-price competition (such as advertising) to convince people to pay a higher price for your cucumbers, since your cucumbers and your neighbors' are virtually identical.

In addition to the market for many agricultural products, another example of markets that have some characteristics of pure competition is the market for foreign exchange (foreign currency). Foreign exchange markets have large numbers of sellers selling identical products, and it is usually the case that no one seller can influence the going price. It is relatively easy to enter the industry, and non-price competition generally does not exist.

MONOPOLISTIC COMPETITION AND YOUR HAIRCUT



If the place where you live is like many other places in the United States, you and your friends have many choices about where to go to get a haircut. The price you pay for a basic haircut probably ranges from a few dollars at a discount establishment to many dollars at an upscale salon. Since there are so many hair stylists, why doesn't competition drive the prices down so that all haircuts cost the same price?

The answer has to do with the type of market structure referred to as monopolistic competition. Hair stylists and many other local businesses such as gas stations, fast-food restaurants, and dry cleaners are similar in many ways to purely competitive markets. There are many competing sellers or firms in the industry; and it is relatively easy to open a business of this type. But in monopolistic competition sellers try to convince customers that their products are different from those of other sellers, and they compete with each other in ways other than by lowering prices. Some people (your parents, if they are paying your bills) might argue that one hair cut is much like another, so why pay one person $60 if you can pay someone else $7? The more expensive hair stylists might respond by claiming that they do better work and know the latest styles, and their haircuts are therefore different from the cheaper ones. Because these hair stylists convince their customers that their haircuts are different, they are able to influence the prices they charge. They do not have to charge the same price every other hair stylist in town charges.

Firms such as hair salons often compete with one another by engaging in non-price competition. They may attract more customers because they have a better location, or because they have more appealing surroundings or more convenient hours. The existence of non-price competition is widespread under monopolistic competition. You can probably think of many examples of how local fast-food restaurants and gas stations compete in ways other than by charging lower prices.

In summary, firms in monopolistic competition have some characteristics that are similar to pure competition, and some characteristics that are similar to pure monopolies. But all in all, they are much more competitive than they are monopolistic.

OLIGOPOLY AND BREAKFAST CEREALS

Oligopoly means that there are a few firms in an industry. A firm in an oligopolistic industry may produce products that differ from those produced by others in the industry (one soap or cereal different from other soaps or cereals, for example), or it may produce products that are virtually identical to products produced by others (copper or glass, for example). Because there are only a few producers, sellers may have significant control over the prices they charge. Because of their small numbers, firms in oligopoly also must pay careful attention to the prices charged by their competitors. For example, if one airline lowers its prices, chances are others will follow. Because oligopolistic firms are often very large companies, it is often difficult for new firms to enter the industry and compete with the existing firms.

One way to determine whether an industry is an oligopoly is to look at the concentration ratio for the industry: the percentage of total output produced by the largest firms. According to data released by the U.S. Census in mid 2001, the four largest breakfast cereal companies (Kellogg, General Mills, Post, and Quaker) were producing over 86 percent of the total amount of breakfast cereals in the United States. The breakfast cereal industry is considered to be highly concentrated and is therefore an oligopoly.

As you have no doubt noticed, cereal producers spend a lot on advertising and use advertising as a way to compete with one another. This expensive form of non-price competition is common in oligopolistic industries that have differentiated products. Other examples of this type of oligopoly are cars, soaps, and airlines. Because advertising on a national scale is so expensive, this is a cost factor that serves to keep competitors out of the industry.

When there are only a few major producers in the industry, there is a possibility of collusion. That is, the firms may get together to try to set prices illegally. Therefore, oligopolies frequently come under the scrutiny of government regulatory agencies such as the Federal Trade Commission (FTC). The FTC investigated the cereal industry in the 1970s and 1980s, but the case was eventually discontinued without action to break up the major companies. And of course, just because there are only a few major producers in an industry does not mean that collusion exists. A few firms can compete with each other as fiercely as a large number of firms.

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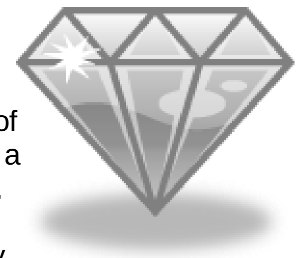
MONOPOLY AND DIAMONDS



The definition of monopoly is fairly easy: A monopoly exists if there is a single seller of a unique product. Coming up with real-life examples of monopolies is not so easy, because most businesses have competition of some sort. If you run the only pizza restaurant in a small town, do you have a monopoly, or do you compete with other types of restaurants? Is the U.S. Postal Service a monopoly, or does it compete with UPS and FedEx? Are professional sports teams in effect geographic monopolies, or do they compete with other forms of entertainment? Economists frequently observe that unless monopolies are sanctioned and protected by governments, or unless they engage in illegal use of force, they tend to self-destruct due to competitive forces. Patents are an example of the means by which a government can sanction a monopoly. The diamond industry is an example of a monopoly that broke up because of its inability to control competition.

Beginning in the 1930s and throughout most of the 20th century, the De Beers company, based in Switzerland and South Africa, controlled most of the world's diamond supply. De Beers provides a good example of a monopoly. Control of the supply of diamonds enabled De Beers to restrict the number of diamonds offered for sale and sell them at higher prices than would exist under competition. To be a monopoly, a company must have strong barriers to entry - that is, ways to keep competitors out of the industry. Over the years, De Beers eliminated its competition principally by buying up all the rough diamonds available. De Beers dealt with potential problems of increasing supply and falling prices by buying and stockpiling diamonds in its London vaults when prices were low and selling them when prices were high. De Beers used non-price competition in the form of advertising ("A Diamond is Forever") to try to keep demand high and to reinforce its brand name.

Toward the end of the century, De Beers began to lose its monopoly control. An Australian diamond producing company chose to withdraw from the monopoly. Russia, although still officially part of the monopoly, began to sell diamonds directly to other countries rather than to De Beers. And discoveries of diamonds in Canada and Africa made it harder for De Beers to control the supply. Ethical issues involved with buying diamonds from warring African countries led to more problems for De Beers. Therefore, in July 2000, De Beers announced that it would no longer attempt to control the world's supply of diamonds, and the monopoly officially ended.

Although cases of pure monopoly are rare, existence of near monopolies may pose problems for an economy. Monopolies exercise strong control over their prices and may have little incentive to be efficient and innovative. In the United States, monopolies are not illegal, but actions firms take to preserve their monopoly are. Monopolies can be prosecuted under antitrust laws, such as occurred with Microsoft in 2000. In other cases, the government may regulate the monopoly, as occurs with many public utilities.