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PRESENTS

BUSINESS STUDIES

TOPIC 1: PRODUCT MARKETS

FORM THREE

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PRODUCT MARKET

The term 'market' is usually used to mean the place where buyers and sellers meet to transact business. In Business studies, however, the term 'market' is used to refer to the interaction of buyers and sellers where there is an exchange of goods and services for a consideration.

> ***NOTE: The contact between sellers and buyers may be physical or otherwise hence a market is not necessarily a place, but any situation in which buying and selling takes place. A market exists whenever opportunities for exchange of goods and services are available, made known and used regularly.***

Definition:

Product market;

It is a particular market in which specific goods and services are sold and with particular features that distinguish it from the other markets. The features are mainly in terms of the number of sellers and buyers and whether the goods sold are homogeneous or heterogeneous. Product market is also referred to as market structure. Markets may be classified according to the number of firms in the industry or the type of products sold in them.

TYPES OF PRODUCT MARKET

The number of firms operating in a particular market will determine the degree of competition that will exist in a given industry. In some markets there are many sellers meaning that the degree of competition is very high, where as in other markets there is no competition because only one firm exists.

When markets are classified according to the degree of competition, there are four main types, these are;

i. Perfect competition

ii. Pure monopoly (monopoly)

iii. Monopolistic competition

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iv. Oligopoly

1. Perfect competition

The word 'perfect' connotes an ideal situation. This kind of situation is however very rare in real life; a perfect competition is therefore a hypothetical situation.

This is a market structure in which there are many small buyers and many sellers who produce a homogeneous product. The action of any firm in this market has no effect on the price and output levels in the market since its production is negligible.

Features of Perfect Competition

a) **Large number of buyers and sellers:** The buyers and sellers are so many that separate actions of each one of them have no effect on the market. This implies that no single buyer or seller can influence the price of the commodity. This is because a single firms (sellers) supply of the product is so small in relation to the total supply in the industry. Similarly, the demand of one buyer is so small compared to the total demand of one buyer is so small compared to the total demand in the market that he/she cannot influence the price.

b) **Firms (suppliers) in such a market structure are therefore price takers** i.e. they accept the prevailing market price for their products.

c) **Identical or homogeneous products:** Commodities from different producers are identical in all aspects e.g. size; brand and quality such that one cannot distinguish them. Buyers cannot therefore show preference for the products of one firm over those of the other.

d) **Perfect knowledge of the market:** Each buyer and seller has perfect knowledge about the market and therefore no one would affect business at any price other than the equilibrium price (market price).If one firm raises the price of its commodity above the prevailing market price, the firm will make no sale since consumers are aware of other firms that are offering a lower price i.e. market

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price. All firms (sellers) are also assumed to know the profits being made by other firms in the industry (in selling the product)

e) **Freedom of entry or exit in the industry;** The buyers and sellers have the freedom to enter and leave the market at will i.e. firms are free to join the market and start production so long as the prevailing market price for the commodity guarantees profit. However if conditions change the firms are free to leave in order to avoid making loss.

f) **In this market structure,** it is assumed that no barrier exists in entering or leaving the industry.

g) **Uniformity of buyers and sellers;** All buyers are identical in the eyes of the seller. There are therefore, no advantages or disadvantages of selling to particular buyers. Similarly, all the sellers are identical and hence there would be no special benefit derived from buying from a certain supplier.

h) **No government interference;** the government plays no part in the operations of the industry. The price prevailing in the market is determined strictly by the interplay of demand and supply. There should be no government intervention in form of taxes and subsidies, quotas, price controls and other regulations.

i) **No excess supply or demand;** the sellers are able to sell all what they supply into the market. This means that there is no excess supply. Similarly, the buyers are able to buy all what they require with the result that there is no difficult in supply.

j) **Perfect mobility of factors of production;** The assumption here is that producers are able to switch factors of production from producing one commodity to another depending on which commodity is more profitable to sell. Factors of production are also freely movable from one geographical area to another.

k) **No transport costs;** the assumption here is that all sellers are located in one area, therefore none of them incurs extra transport costs or carriage of goods. The sellers cannot hence charge higher prices

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to cover the cost of transport. Buyers, on the other hand, would not prefer some sellers to others in an attempt to cut down on transport costs.

NOTE: The market (perfect competition) has normal demand and supply curves. The individual buyers demand curve is however; perfectly elastic since one can buy all what he/she wants at the equilibrium price. Similarly, the individual sellers supply curve is also perfectly elastic because one can sell all what he/she produces at the equilibrium price.

Perfect competition market hold on the following assumptions;

i. There are no transport costs in the industry
ii. Buyers and sellers have perfect knowledge of the market
iii. Factors of production are perfectly mobile
iv. There is no government interference

Examples of perfect competitions are very difficult to get in the real life but some transactions e.g. on the stock exchange market, are very close to this.

Criticism of the concept of perfect competition

In reality, there is no market in which perfect competition exists. This is due to the following factors:

a) Very few firms produce homogenous products. Even if the products were fairly identical, consumers are unlikely to view them as such.
b) In real situations, consumers prefer variety for fuller satisfaction of their wants; hence homogenous products may not be very popular in these circumstances.
c) There is a common tendency towards large-scale operation. This tendency works against the assumption of having many small firms in an industry.
d) Firms are not found in one place to cut down on transport costs as this market structure requires.

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e) Governments usually interfere in business activities in a variety of ways in the interest of their citizens. The assumption of non-interference by the state is therefore unrealistic in real world situations.

f) Information does not freely flow in real markets so as to make both sellers and buyers fully knowledgeable of happenings in all parts of a given market.

2. MONOPOLY

A monopoly is a market structure in which only one firm produces a commodity which has no close substitutes.

Some of the features in this market structure are:

a) One seller or producer; supplying the entire market with a product that has no close substitute consumers therefore have no option but to use the commodity from the monopolist to satisfy their need.

b) Many unorganized buyers; in the market the buyers compete for the commodity supplied by the monopoly firm.

c) The monopoly firm is the industry; because it supplies the entire market, the firms supply curve is also the market supply curve, and the demand curve of the firm is also the market demand curve.

d) Entry into the market is closed; such barriers are either put by the firm or they result from advantages enjoyed by the monopoly firm e.g. protection by the government.

e) Huge promotional and selling costs; are incurred in order to expand the market base and to maintain the existing market. This also helps to keep away potential competitors.

f) The monopoly firm is a price maker or a price giver; the firm determines the price at which it will sell its output in the market. It can therefore increase or reduce the price of its commodity, depending on the profit it desires to make.

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g) Price Discrimination is may be possible; This is a situation where the firm charges different prices for same commodity in different markets.

Price discrimination may be facilitated by conditions such as;

- ✓ Consumers being in different markets such that it is difficult for one to buy the product in the market where it is cheaper.
- ✓ The production of the commodity is in the hands of a monopolist.
- ✓ Market separation.

Market separation may be based on the following factors;

- ✓ **Geographical;** Goods may be sold at different prices in different markets.
- ✓ **Income;** Seller may charge different prices for his/her products to different categories of consumers depending on their income.
- ✓ **Time;** a firm may sell the same commodity at a higher price during the peak period and lower the price during the off peak period.

Sources of monopoly power

i. **Control of an important input in production;** a firm may control a strategic input or the entire raw materials used in the production of a commodity. Such a firm will easily acquire monopoly by not selling the raw materials to potential competitors.

ii. **Ownership of production rights;** where the right to production or ownership of commodity i.e. patent rights, copyrights and royalties belong to one person or firm, then, that creates a monopoly. Similarly, if the government gives license to produce a commodity to one firm, then this will constitute a monopoly.

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iii. **Internal economies of scale;** The existence of internal economies of scale that enable a firm to reduce its production costs to the level that other firms cannot will force these other firms out of business leaving the firm as a monopoly.

iv. **Size of the market;** where the market is rather small and can only be supplied profitably by one firm.

v. **Additional costs by other firms;** a firm may enjoy monopoly position in a particular area if other firms have to incur additional costs such as transport in order to sell in the area. These additional costs may increase the prices of the commodity to the level that it becomes less attractive hence giving the local firm monopoly status.

vi. **Where a group of firms combine to act as one;** some firms may voluntarily combine/amalgamate or work together for the purpose of controlling the market of their product. Examples are cartels

vii. **Restrictive practices;** a firm may engage in restrictive practices in order to force other firms of business and therefore be left as a monopoly. Such practices may include limit pricing i.e. where a firm sells its products at a very low price to drive away competitors.

viii. **Financial factors;** where the initial capital outlay required is very large, thereby preventing other firms from entering the market.

ix. Where the government establishes a firm and gives it monopoly power to produce and sell 'cheaply'(Government Policy)

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Advantages of monopoly

a) A monopoly is able to provide better working conditions to employees because of the high profits realized

b) In some monopolies, high standards of services/goods are offered

c) Monopolies always enjoy economies of scale. This may help the consumer in that the goods supplied by a monopoly will bear lower prices.

d) A monopolist may use the extra profit earned to carry out research and thus produce higher quality goods and services.

e) The consumer is protected in that essential services such as water and power supply is not left to private businesses who would exploit the consumers.

Disadvantages of monopoly

i. A monopolist can control output so as to charge high prices
ii. Consumers lack freedom of choice in that the product produced by a monopoly has no substitute
iii. Low quality products may be availed to consumers due to lack of competition.

3. MONOPOLISTIC COMPETITION

Monopolistic competition is a market structure that falls within the range of imperfect competition i.e. falls between perfect competition and pure monopoly. It is therefore a market structure that combines the aspects of perfect competition and those of a monopoly.

Since it is not possible to have a market that is perfectly competitive or a market that is pure monopoly in real world, all market structures in real world lie between the two and are thus known as imperfect market structures.

In a monopolistic market, there are many sellers of a similar product which is made to look different. This is known as product differentiation. These similar products are made different through packaging, design, colour, branding etc.

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The following are the assumptions of a monopolistic competition.

i. **A large number of sellers;** who operate independently.
ii. **Differentiated products;** each firm manufactures a product which is differentiated from that of its competitors, yet they are relatively good substitutes of each other. The differences may be real in that

different materials are used to make the product or may be imaginary i.e. created through advertising, branding, colour, packaging etc.

iii. **No barriers to entry or exit from industry;** There is freedom of entry into the industry for new firms and for existing firms to leave the industry.

iv. **Firms set their own prices;** the prices are set depending on the costs incurred in production and the demand in the market.

v. **No firm has control over the factors of production;** each firm acquires the factors at the prevailing market prices.

vi. **Presence of non-price competitions;** since products are close substitutes of each other, heavy advertising and other methods of product promotion are major characteristics of firms in monopolistic competition.

vii. Buyers and sellers have perfect knowledge of the market.

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4. OLIGOPOLY

This is a market structure where there are few firms. The firms are relatively large and command a substantial part of the market. It is a market structure between the monopolistic competition and monopoly.

Types of Oligopoly

Oligopoly may be classified according to the number of firms or the type of products they sell. They include:

a) Duopoly; this refers to an oligopoly market structure which comprises of two firms. Mastermind Tobacco and British American Tobacco (BAT) are examples of duopoly in Kenya.

b) Perfect/Pure oligopoly refers to an oligopolistic market that deals in products which are identical. Examples of pure oligopoly are companies dealing with petroleum products such as oil Libya, Caltex, Total, Shell, National Oil, Kenol and Kobil. These firm sell products which are identical such as kerosene, petrol and diesel.

c) Imperfect/Differentiated Oligopoly; this is an oligopolistic market structure where firm have products which are the same but are made to appear different through methods such as packaging, advertising and branding.

Features of oligopoly

i. Has few large sellers and many buyers.
ii. The firms are interdependent among themselves especially in their output and pricing.
iii. Non-price competition, firms are in a position to influence the prices. However, they try to avoid price competition for the fear of price war.
iv. There is barriers to entry of firms due to reasons such as; requirement of large capital, Ownership of production rights, control over crucial raw materials, Restrictive practices etc.
v. High cost of selling through methods of advertisement due to severe competition.
vi. Products produced are either homogeneous or differentiated.
vii. Uncertain demand curve due to the inter-dependence among the firms. Hence the shifting of the demand curve is not definite.
viii. There is price rigidity i.e. once a price has been arrived at in an oligopolistic market, it tends to remain stable.

This feature explains why a firm in oligopolistic market faces two sets of demand curves resulting to a Kinked Demand Curve. One curve, for prices above the determined one, which is fairly gentle and the other curve for prices below the determined one which is fairly steep.

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