

2015:

QUE.4.

a) What is Market? Give area wise classification of Market.

Ans: Definition – What is Market?

The term 'market' originated from Latin word 'marcatu' having a verb 'mercari' implying 'merchandise' 'ware traffic' or 'a place where business is conducted'. For a layman, the word 'market' stands for a place where goods and persons are physically present. For him, 'market' is 'market' who speaks of 'fish market', 'mutton market', 'meat market', 'vegetable market', 'fruit market', 'grain market'. For him, it is a congregation of buyers and sellers to transact a deal.

However, for us as the students of marketing, it means much more. In a broader sense, it is the whole of any region in which buyers and sellers are brought into contact with one another and by means of which the prices of the goods tend to be equalized easily and quickly.

Classification of Markets—Traditional:

Markets can be classified on different bases of which most common bases are: area, time, transactions, regulation, and volume of business, nature of goods, and nature of competition, demand and supply conditions. This classification is off-shoot of traditional approach.

Traditionally, a market was a physical place where buyers and sellers gathered to buy and sell the goods. Economists describe a market as a collection buyers and sellers who transact over a particular product or product class.

A. On the Basis of Area:

Using area, there can be local, regional, national and international markets.

Local markets: Local markets confine to locality mostly dealing in perishable and semi-perishable goods like fish, flowers, vegetables, eggs, milk, and others.

Regional markets: Regional market covers a wider area may be a district, a state or inter-state dealing in durables both consumer and non durables and industrial products, including agricultural produce.

National markets: In case of national markets the area covered are national boundaries dealing in durable and non-durable consumer goods, industrial goods, metals, forest products, agricultural produce.

International markets: In case of world or international market, the movement of goods is widespread throughout the world, making it as a single market. It should be noted that due to the latest technologies in transport, storage and packaging, even the most perishable goods are sold all over the world, not that only durables.

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Extra topics:

B. On the basis of Time:

The time duration is the factor. Accordingly, there can be short period and long period markets. Short-period markets are for highly perishable goods of all kinds and long-period markets are for durable goods of different varieties may be produced or manufactured.

C. On the basis of Transactions:

Taking the nature of transactions, these can be 'spot' and 'future' markets. In 'spot' market, once the transaction takes place, the delivery takes place, while in case of future markets, transactions are finalized pending delivery and payment for future dates.

D. On the basis of Regulation:

Taking regulation, markets can be regulated and non-regulated. A 'regulated market' is one in which business dealings take place as per set rules and regulations regarding, quality, price, source changes and so on.

These can be in agricultural products or produce and securities. On the other hand, unregulated market is a free market where there are no rules and regulations; even if they are there, they are amended as per the requirements of parties of exchange.

E. On the Basis of Volume of Business:

Taking volume of business as a basis, there can be two types of markets namely, "Wholesale" and "Retail". Wholesale markets are featured by large volume business and wholesalers.

On the other hand, 'Retail' markets are those where quantity bought and sold is on small-scale. The dealers are retailers who buy from wholesalers and sell back to consumers.

F. On the basis of Nature of Goods:

Taking the nature of goods, there can be commodity markets, capital markets. 'Commodity' markets deal in favour of material, produce, manufactured goods may be consumer and industrial and bullion market dealing precious metals.

'Capital' market is a market for finance. These markets can be subdivided into 'money' market dealing in lending, and borrowing of money; 'Securities' market or 'stock' market dealing in buying and selling of shares and debentures and 'foreign exchange' market where it is a forex market dealing buying and selling of foreign currencies may be hard or soft.

G. On the basis of Nature of Competition:

Based on competition or competitive forces, there can be variety of markets for a product or service. However, only two are the most important namely, perfect and imperfect.

A 'perfect' market is one which is characterized by:

- (a) Large number of buyers and sellers
- (b) Prevalence of single lowest price for products those are 'homogeneous'
- (c) The perfect knowledge on the part of buyers and sellers
- (d) Free entry and exit of firms in market. These types for markets exist hardly.

The other one is 'imperfect' which is featured by:

- (a) Products may be similar but not identical
- (b) Different prices for a class of goods
- (c) Existence of physical and psychological barriers on movement of goods
- (d) No perfect knowledge of products and other dimensions on the part of buyers and sellers.

H. On the basis of Demand and Supply:

Based on demand and supply conditions or hold of buyers and sellers, there can be seller's and buyer's markets. A seller's market is one where sellers are in driver's seat and the buyers are at the receiving end.

In other words, it is a situation where demand for goods exceeds supply. On the other hand, buyer's market is one where buyers are in commanding position. That is, supply is exceeding the demand for the goods.

Classification of Markets—Modern:

The modern classification is based on the consumer orientation because in modern economic system consumer is the king-pin and a decisive driving force.

Accordingly, the marketing experts have identified markets based on such broad-based classification namely, consumer, business, global and, non-profit and government markets.

Consumer Markets: These markets specialize in selling mass consumer durable and nondurable products and services devote good deal of time in an attempt to establish a superior brand image. These items may be shoes, apparels, clothing, household items like television, sound system, washing machines, fans, on one hand and tea, coffee, tea powder, coffee powder, biscuits, bread spreads, dental cream, personal care beauty-aids, rice, wheat, oat, gourmet mixes and so on the other.

Much of the brand's strength rests on developing a superior product and packaging, ensuring its availability and backing with engaging communications and reliable service. This task of image building is really ticklish as consumer market goes on changing its colour over the period of time.

Business Markets:

This is a market of business buyers and sellers. Business buyers buy goods with a view to make or resell a product to others at a profit. Therefore, business marketers are to effectively demonstrate as to how their products will help the buyers in getting higher revenue or lower costs.

Therefore, companies selling business goods and services often face well-trained and well informed professional buyers who are skills in evaluating competitive offerings.

These markets deal in raw-materials, fabricated-parts, appliances, equipments, supplies and services that become the part of end products of the business consumers. Advertising plays its due role.

However, personal selling has the upper hand. Product price, quality and business suppliers' reputation have significant role.

Global Markets:

Global markets consist of buyers and sellers all over the world. The companies selling goods and services in the global market place play global gain involving decisions and challenges.

To be successful, they must decide as to which country to enter?

How to enter each country?

That is, as an exporter, license partner of a joint venture, contract manufacturer or only manufacturer, how to adapt their product and source features to each country?

How to price their products in different countries?

And how to adapt their communications to differing cultures of various countries?

These decisions are to be made in the face of differing requirements for buying, negotiating, owning, and disposing of property under different culture, language, and legal and political systems; and the foreign currency that is subject to fluctuations having its own implications. It is needless to say that these goods and services both consumer and industrial or business.

Non-profit and Government Markets:

Companies do sell their products and services to non-profit organizations like temples, churches, universities, charitable institutions and to governmental departments at local, state and central level. The companies that market their products and services have to consider the price aspect because these buyers have limited purchasing power.

Again, lower prices badly affect the features and quality of products and services if an attempt is made to design such an offering.

Hence, these buyers buy through bidding where lowest bid is favoured as there is no alternative. They also need longer period of credit.

b) What are the features of the perfect completions?

Ans: Features of Perfect Competition

1. Large number:

In perfect competition, there must be large number of buyers and sellers. Each buyer buys a small quantity of the total amount. Each seller is so large that no single buyer or seller can influence the price and affect the market. According to Scitovsky buyers and sellers are price takers in the purely competitive market. Each seller (or firm) sells its products at the price determined by the market. Similarly, each buyer buys the commodity at the price determined by the market.

2. Homogeneous product:

Under perfect competition, the product offered for sale by all the seller must be identical in every respect. The goods offered for sale are perfect substitutes of one another. Buyers have no special preference for the product of a particular seller. No seller can raise the price above the prevailing price or lower the price below the prevailing price.

3. Free entry and exit:

Under perfect competition, there will be no restriction on the entry and exit of both buyers and sellers. If the existing sellers start making abnormal profits, new sellers should be able to enter the market freely. This will bring down the abnormal profits to the normal level. Similarly, when losses will occur existing sellers may leave the market. However, such free entry or free exit is possible only in the long run, but not in the short-run.

4. Perfect knowledge:

Perfect competition implies perfect knowledge on the part of buyers and sellers regarding the market conditions. As a results, no buyer will be prepared to pay a price higher than the prevailing price. Sellers will not charge a price higher or lower than the prevailing price. In this market, advertisement has no scope.

5. Perfect mobility of factors of production:

The second perfection mobility of factors of production from one use to another use. This feature ensures that all sellers or firms get equal advantages so far as services of factors of production are concerned. This is essential to enable the firms and industry to achieve equilibrium.

6. Absence of transport cost:

Under perfect competition transport, cost does not exist. Since commodities have, the same price it logically follows that there will be no transport cost. In the event of the presence of cost of transport, there will be no single price in the market. Transport cost occurs when there is no perfect knowledge of the market conditions on the part of buyers and sellers.

7. No attachment:

There is no attachment between the buyers and sellers under perfect competition. Since products of all sellers are identical and their prices are the same a buyer is free to buy the commodity from any seller he likes. He has no special inclination for the product of any seller as in case of monopolistic competition or oligopoly. Theoretically, perfect competition is irrelevant. In reality, it does not exist. So it is a myth.

c) Explain the features of monopolistic competition.

Ans: Monopolistic Competition refers to a market situation in which there are large numbers of firms which sell closely related but differentiated products. Markets of products like soap, toothpaste AC, etc. are examples of monopolistic competition.

Features of Monopolistic Competition:

1. Large Number of Sellers:

There are large numbers of firms selling closely related, but not homogeneous products. Each firm acts independently and has a limited share of the market. So, an individual firm has limited control over the market price. Large number of firms leads to competition in the market.

2. Product Differentiation:

Each firm is in a position to exercise some degree of monopoly (in spite of large number of sellers) through product differentiation. Product differentiation refers to differentiating the products on the basis of brand, size, colour, shape, etc. The product of a firm is close, but not perfect substitute of other firm.

Implication of 'Product differentiation' is that buyers of a product differentiate between the same products produced by different firms. Therefore, they are also willing to pay different prices for the same product produced by different firms. This gives some monopoly power to an individual firm to influence market price of its product.

Explore More about Product Differentiation:

1. The product of each individual firm is identified and distinguished from the products of other firms due to product differentiation.

2. To differentiate the products, firms sell their products with different brand names, like Lux, Dove, Lifebuoy, etc.

3. The differentiation among different competing products may be based on either 'real' or 'imaginary' differences.

(i) Real Differences may be due to differences in shape, flavour, colour, packing, after sale service, warranty period, etc.

(ii) Imaginary Differences mean differences which are not really obvious but buyers are made to believe that such differences exist through selling costs (advertising).

4. Product differentiation creates a monopoly position for a firm.

5. Higher degree of product differentiation (i.e. better brand image) makes demand for the product less elastic and enables the firm to charge a price higher than its competitor's products. For example, Pepsodent is costlier than Babool.

6. Some more examples of Product Differentiation:

(i) Toothpaste: Pepsodent, Colgate, Neem, Babool, etc.

(ii) Cycles: Atlas, Hero, Avon, etc.

(iii) Tea: Brooke Bond, Tata tea, Today tea, etc.

(iv) Soaps: Lux, Hamam, Lifebuoy, Pears, etc.

3. Selling costs:

Under monopolistic competition, products are differentiated and these differences are made known to the buyers through selling costs. Selling costs refer to the expenses incurred on marketing, sales promotion and advertisement of the product. Such costs are incurred to persuade the buyers to buy a particular brand of the product in preference to competitor's brand. Due to this reason, selling costs constitute a substantial part of the total cost under monopolistic competition.

It must be noted that there are no selling costs in perfect competition as there is perfect knowledge among buyers and sellers. Similarly, under monopoly, selling costs are of small amount (only for informative purpose) as the firm does not face competition from any other firm.

4. Freedom of Entry and Exit:

Under monopolistic competition, firms are free to enter into or exit from the industry at any time they wish. It ensures that there are neither abnormal profits nor any abnormal losses to a firm in the long run. However, it must be noted that entry under monopolistic competition is not as easy and free as under perfect competition.

5. Lack of Perfect Knowledge:

Buyers and sellers do not have perfect knowledge about the market conditions. Selling costs create artificial superiority in the minds of the consumers and it becomes very difficult for a consumer to evaluate different products available in the market. As a result, a particular product (although highly priced) is preferred by the consumers even if other less priced products are of same quality.

6. Pricing Decision:

A firm under monopolistic competition is neither a price-taker nor a price-maker. However, by producing a unique product or establishing a particular reputation, each firm has partial control over the price. The extent of power to control price depends upon how strongly the buyers are attached to his brand.

7. Non-Price Competition:

In addition to price competition, non-price competition also exists under monopolistic competition. Non-Price Competition refers to competing with other firms by offering free gifts, making favourable credit terms, etc., without changing prices of their own products.

Firms under monopolistic competition compete in a number of ways to attract customers. They use both Price Competition (competing with other firms by reducing price of the product) and Non-Price Competition to promote their sales.

MARKET: 2014: Que. No. 5

a. What are the features of perfectly competitive market structure?(Repeating again)

Ans: The features of perfectly competitive market structure:

(1) Large number of buyers and sellers:

Under perfectly competitive market there is large number of buyers and sellers. The position of a single seller in the market is just like a drop in the ocean. Each buyer purchases only a small quantity of the total amount. Each buyer and seller has no ability to influence the ruling price by their independent action.

The price under perfect competition is given and each seller adjusts its sale to earn maximum profits. Under perfect competition the sellers of a commodity is the price taker and output adjuster and not price makers. They take the market price as a given datum.

(2) Homogeneous Products:

The second condition of perfect competition is that the products sold by the suppliers are fully homogeneous. The commodities available everywhere are the same. The products of various sellers are indistinguishable from each other. They are perfect substitutes for one another.

The cross elasticity between the products is infinite. The commodities are perfectly similar in quality, quantity, size and shape. The buyers are indifferent to any commodity sold in the market. If the commodities sold in the market were differentiated, each seller would influence over the price of his own variety.

The control over price is removed only when all the sellers are producing homogenous products. Thus in a perfectly competitive market, buyers have no other basis of attaching to one seller for purchasing a product other than price.

(3) Uniform price:

Under perfect competition the ruling market price is the same. Price is uniform as the products in the market are identical. Price is fixed by all the buyers and sellers in the market. No Individual effort of a buyer or seller goes to determine price.

If any miller sells at the price less than prevailing price, the demand for his commodity will be so high that he will not be able to supply the commodities at low price to the increased demand. On the other hand if a seller sells at a price higher than the ruling market price, he will lose by doing so as most of his customers will leave him for his higher price.

(4) Free entry and free exit:

Under perfect competition buyers and sellers are absolutely free to enter and leave the market. No restriction is imposed on their entry and exit. Under perfect competition firms get only normal profit. At this normal profit there is no tendency on the part of the existing firms to leave the market or the new firms to leave market.

But at abnormal profit and abnormal loss, firms tend to enter and leave the market according" to their will. Thus on the basis of profit and loss firms are at liberty to enter or quit the market.

(5) Perfect knowledge about the market:

One of the most pre-requisite of perfect competition is that both buyers' and-sellers must have perfect knowledge about the conditions of the market. Sellers must know the ruling market price charged by other sellers from the buyers. Similarly buyers It in know the prices charged by different sellers.

This condition is highly essential for a competitive market. Single price and homogeneous commodity can not prevail if the buyers remain ignorant of the market. When all the buyers can know the price fend the uniform quality of the commodity, nobody will offer more fend therefore single price prevails in the "market,

(6) Perfect mobility:

Under perfect competition it is understood that various factors of production are perfectly mobile within the industry. Factors of production can freely move from one occupation to another and from one place to another. There is no barrier on their movement. Factors move from place to place in search of higher wage. There should not be any kind of imposition on the mobility of resources.

(7) Absence of transport cost:

In a perfectly competitive market there is single unit price. Price being charged by the firms is free of transportation cost. Price is not affected by the cost of transportation of goods. The market price charged by different sellers does not differ due to location of different sellers in the market.

No seller is near or distant to any buyers. Thus there is no transportation cost from one part of the market to the other. Perfectly competitive market is a myth. Such a market is never found in the real world. It is an ideal. As an ideal market it compares the price and profit condition in imperfect market.

b. In the long run, every firm under perfect competition earns only normal profit. Explain.

Ans: Equilibrium of the industry in the long run:

The industry is in long-run equilibrium when a price is reached at which all firms are in equilibrium (producing at the minimum point of their LAC curve and making just normal profits). Under these conditions there is no further entry or exit of firms in the industry, given the technology and factor prices. The long-run equilibrium of the industry is shown in figure 5.15. At the market price, P, the firms produce at their minimum cost, earning just normal profits. The firm is in equilibrium because at the level of output X.

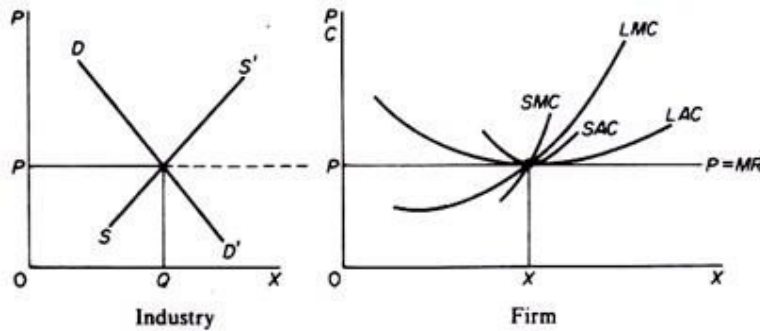


Figure 5.15

$$LMC = SMC = P = MR$$

This equality ensures that the firm maximizes its profit. At the price P the industry is in equilibrium because profits are normal and all costs are covered so that there is no incentive for entry or exit. That the firms earn just normal profit (neither excess profits nor losses) is shown by the equality

$$LAC = SAC = P$$

which is observed at the minimum point of the LAC curve. With all firms in the industry being in equilibrium and with no entry or exit, the industry supply remains stable, and, given the market demand (DD' in figure 5.15), the price P is a long-run equilibrium price.

Since the price in the market is unique, this implies that all firms in the industry have the same minimum long-run average cost. This, however, does not mean that all firms are of the same size or have the same efficiency, despite the fact that their LAC is the same in equilibrium. The more efficient firms employ more productive factors of production and/or more able managers.

These more efficient factors must be remunerated for their higher productivity, otherwise they will be bid off by the new entrants in the industry. In other words, as the price rises in the market the more efficient firms earn a rent which they must pay to their superior resources. Thus rents of more efficient factors become costs for the individual firm, and hence the LAC of the more efficient firms shifts upwards as the market price rises, even if the factor prices for the industry as a whole remain constant as the industry expands.

In this situation the LAC of the old, more efficient, firms must be redrawn so as to be tangent at the higher market price. The LMC of the old firms is not affected by the rents accruing to its more productive factors. (It will be shifted only if the prices of factors for the industry in general increase.) Thus the more efficient firms will be in equilibrium, producing that output at which the redrawn LAC is at its minimum (at which point the LAC is cut by the initial LMC given that factor prices remain constant).

Under these conditions, with the superior, more productive resources properly costed at their opportunity cost, all firms have the same unit cost in their long-run equilibrium. This is shown in figure 5.16. At the initial price P_0 the second firm was not in the industry as it could not cover its costs at that price. However,

at the new price, P_1 firm B enters the industry, making just normal profits. The established firm A earns rents which are imputed costs, so that its LAC upwards and it reaches a new long-run equilibrium a higher level of output (X'_A).

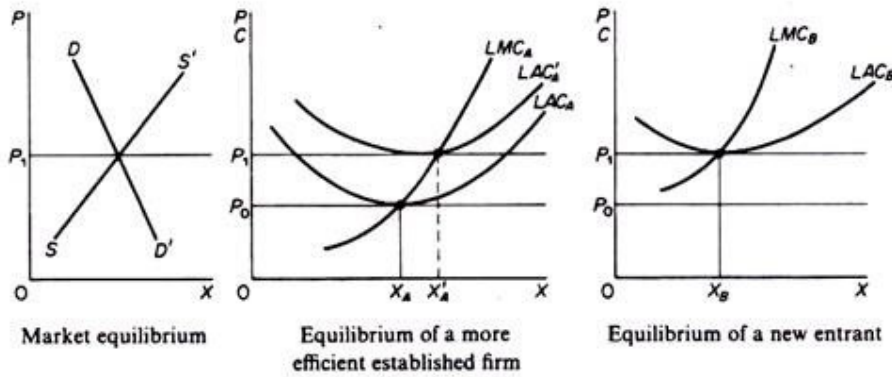


Figure 5.16

Optimal resources allocation:

In perfect competition the market mechanism leads to an optimal allocation of resources.

The optimality is shown by the following conditions which prevail in the long-run equilibrium of the industry:

- (a) The output is produced at the minimum feasible cost.
- (b) Consumers pay the minimum possible price which just covers the marginal cost of the product, that is, price = opportunity cost.
- (c) Plants are used at full capacity in the long run, so that there is no waste of resources.
- (d) Firms only earn normal profits.

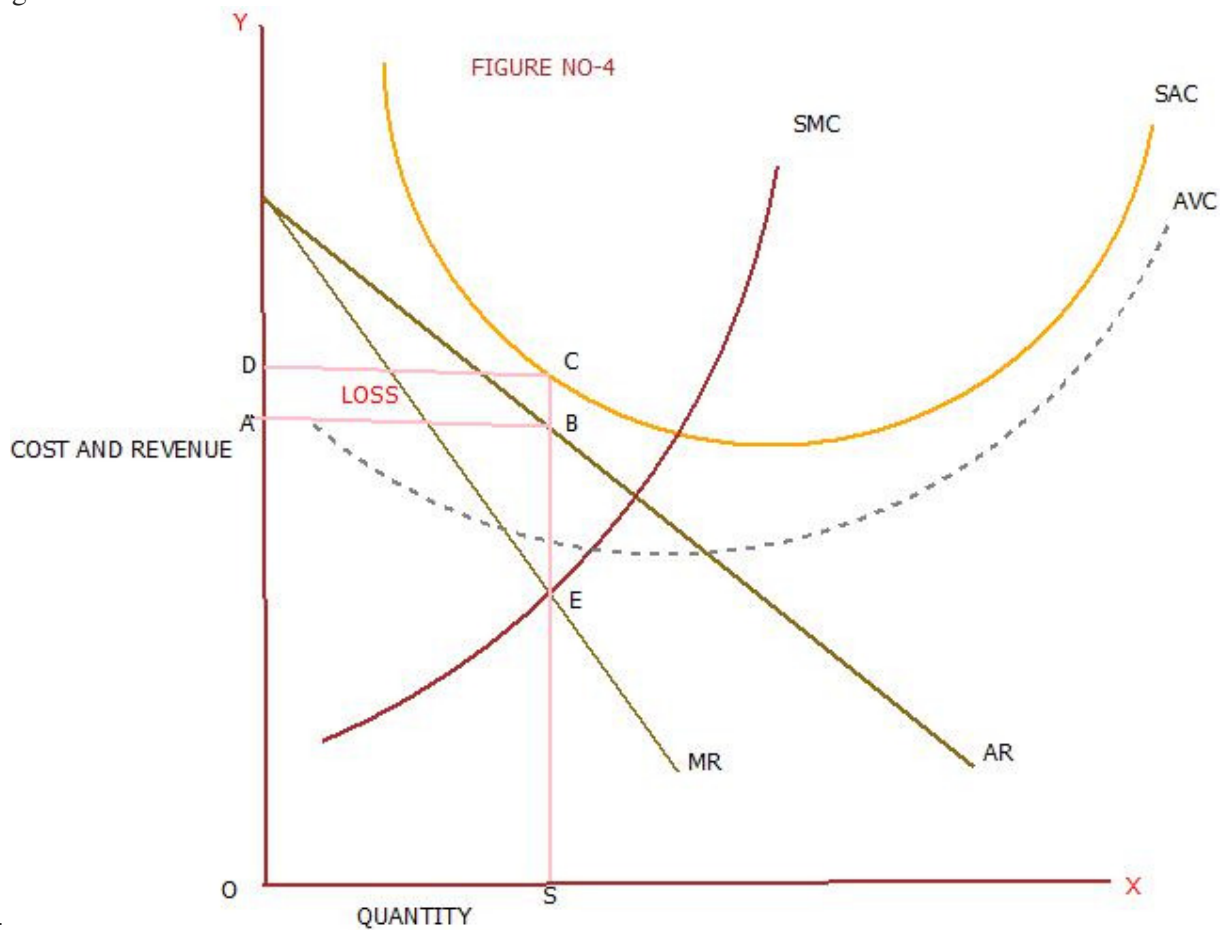
In the long run these conditions prevail in all markets, so that resources are optimally allocated in the economy as a whole. If we assume for simplicity that there are only two commodities (x and y) produced in the economy we may present the allocation of the given resources of the economy with the familiar production-possibility curve. The preferences of the consumers in the economy may be shown by community indifference curves.

c. In a short run, a producer may operate with losses under perfect competition.Explain.

Ans: Short-run equilibrium (with losses) under monopoly:

It is generally believed that monopolist always earn profits .In the short-run, if the demand is not sufficient monopolist can make losses. At times of recession or depression or and kind of crises demand for goods decreases and monopolist has to suffer losses .But if the losses continued for a long time then the monopolist will shut down his present business in the long run .But in the short run he will continue in his present business so long as his price is greater than the average variable cost. When losses exceed total fixed costs and the monopolist will not be able to cover his variable cost fully, the monopolist would stop production in the short-run.

Figure-



4

The monopolist is in equilibrium at OS level of output, where OP price is determined. This case price is greater than average cost therefore the monopolist is making losses is equal to the area of the rectangle ABCD.As price is higher than average variable cost ,the monopolist will continue his production in the short run. From the above discussion we can conclude that demand for the product plays an important role in determining whether the monopolist will get profit or make losses.

MARKET: 2013 Que. No.5

a. Describe the features of market structures.

Ans. Repeating again.

b. Explain kinky demand curve prevailing in oligopoly market.

The kinked demand curve model of oligopoly:

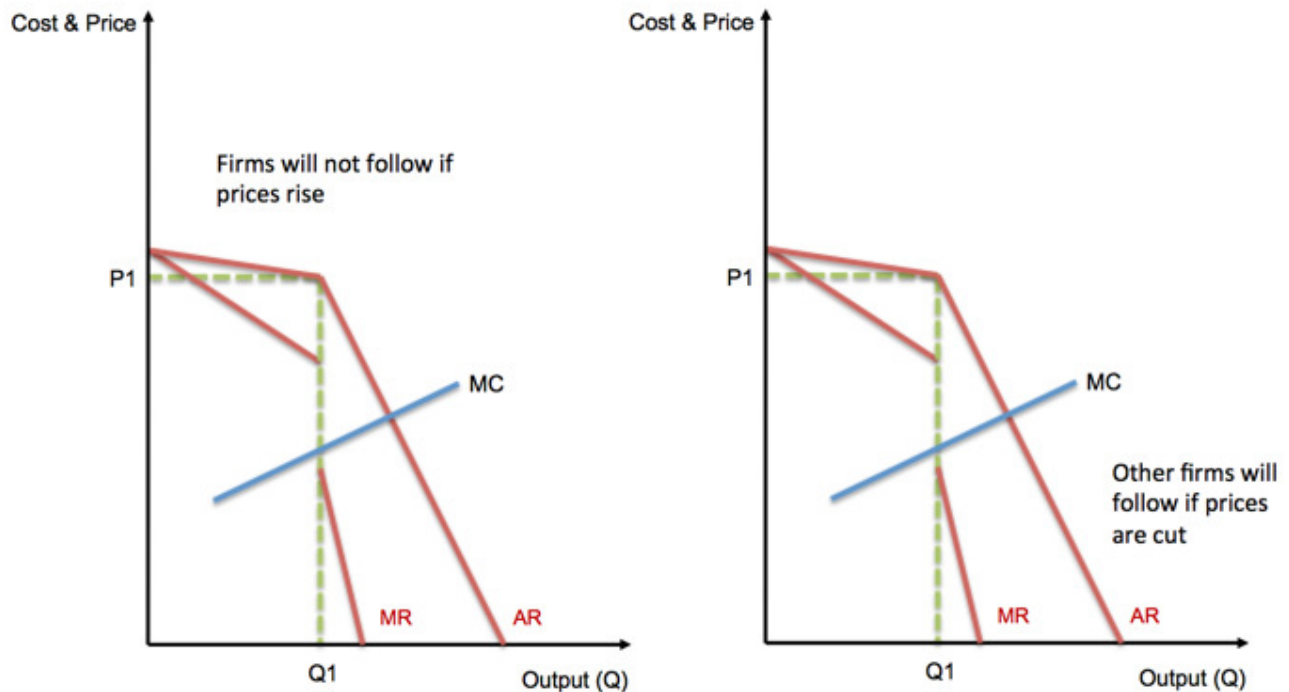
The **kinked demand curve** model assumes that a business might face a **dual demand curve** for its product based on the **likely reactions of other firms** to a change in its price or another variable.

What are the assumptions of likely behaviour of firms in this model?

- The assumption is that firms in an oligopoly are looking to **protect and maintain their market share** and that **rival firms are unlikely to match another's price increase** but may **match a price fall**. I.e. rival firms within an oligopoly react asymmetrically to a change in the price of another firm.
- If a business raises price and others leave their prices constant, then we can expect quite a large **substitution effect** making **demand relatively price elastic**. The business would then lose market share and expect to see a fall in its total revenue.
- If a business reduces its price but other firms follow suit, the **relative price change is smaller** and demand would be inelastic. Cutting prices when demand is inelastic leads to a fall in revenue with little or no effect on market share.

The Kinked Demand Curve Analysis Diagram

Analysis Diagram: The Kinked Demand Curve Model



Analysis diagram of the kinked demand curve

Is there a stable profit maximising equilibrium in this model?

The kinked demand curve model makes a prediction that a **business might reach a stable profit-maximising equilibrium at price P1 and output Q1** and have little incentive to alter prices.

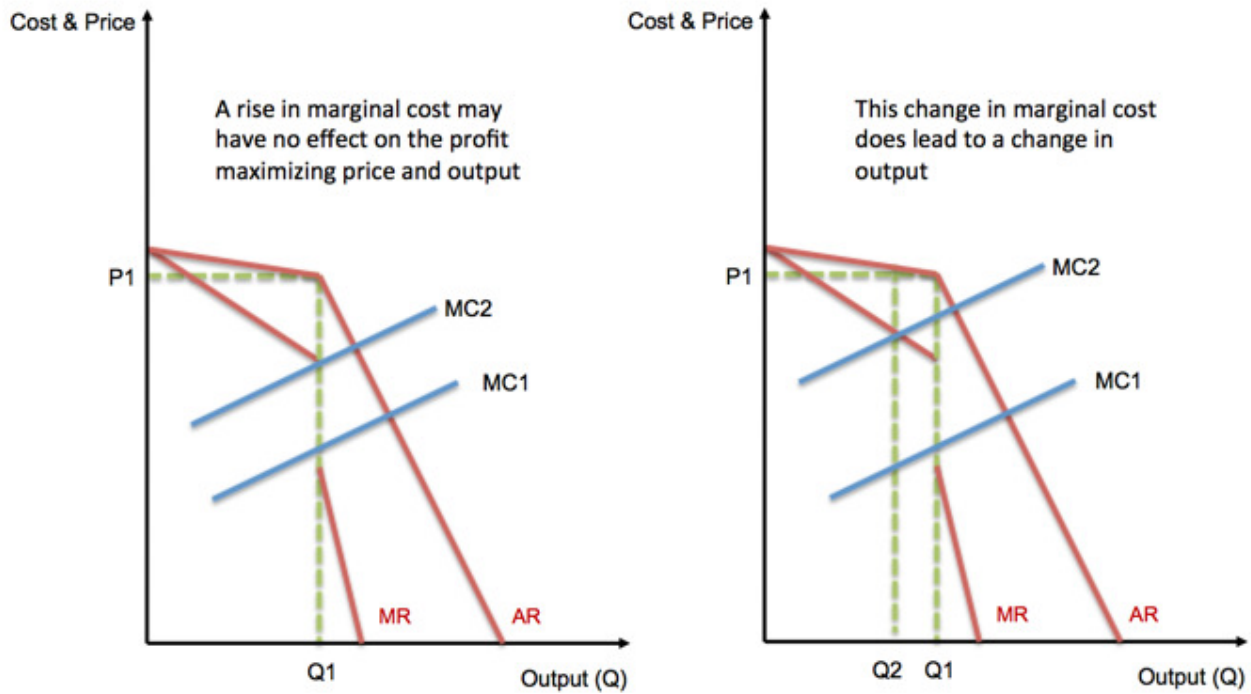
- The kinked demand curve model predicts there will be **periods of relative price stability** under an oligopoly with businesses focusing on **non-price competition** as a means of reinforcing their market position and increasing their supernormal profits.
- Short-lived price wars between rival firms can still happen under the kinked demand curve model. During a price war, firms in the market are seeking to snatch a short term advantage and win over some extra market share.

Recent examples of price wars include the major UK supermarkets, price discounting of computers in China and a price war between cross channel speed ferry services. Price competition is frequently seen in the telecommunications industry.

Changes in costs using the kinked demand curve analysis

- One prediction of the kinked demand curve model is that changes in variable costs might not lead to a rise or fall in the profit maximising price and output.
- This is shown in the next diagram where it is assumed that a rise in costs such as energy and raw material prices leads to an upward shift in the marginal cost curve from MC1 to MC2.
- Despite this shift, the equilibrium price and output remains at Q1.
- It would take another hike in costs to MC3 for the price to alter.

Analysis Diagram: Changes in marginal cost



Changes in marginal cost

Kinked Demand Curve – Overview

On oligopoly firms have price-setting power **but may be reluctant to use it**

Rivals unlikely to match a price rise and rivals likely to match a price fall

If a firm is settled on one price, there may be little point in changing it

Even if costs change we often see price rigidity / stability in an oligopoly

This increases the importance attached to non-price competition

Overview

- There is **limited real-world evidence** for the kinked demand curve model.
- The theory can be criticised for not explaining *why* firms start out at the equilibrium price and quantity.
- That said it is one possible model of how firms in an oligopoly *might* behave if they have to consider the responses of their rivals.

OR

Oligopoly Models: Sweezy's Kinked Demand Curve Model and Collusion Model

Under oligopoly, prices and output are indeterminate. Moreover, organizations are mutually dependent on each other in setting the pricing policy.

Therefore, economists found it extremely difficult to propound any specific theory for price and output determination under oligopoly.

In the words of Maurice, "there is no theory of oligopoly in the sense that there is a theory of perfect competition or of monopoly. There is no unique general solution but merely many different behavioral

models, each of which reaches a different solution.” Thus, the economists have developed various analytical models based on different behavioral assumptions for determining price and output under oligopoly.

Figure-1 shows different oligopoly models:

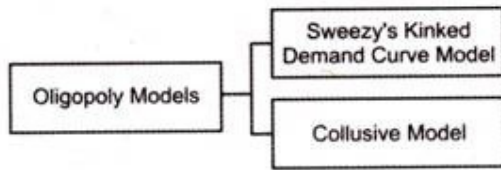


Figure-1: Oligopoly Models

Let us discuss different oligopoly models (as shown in Figure-1).

1. Sweezy's Kinked Demand Curve Model:

The kinked demand curve of oligopoly was developed by Paul M. Sweezy in 1939. Instead of laying emphasis on price-output determination, the model explains the behavior of oligopolistic organizations. The model advocates that the behavior of oligopolistic organizations remain stable when the price and output are determined.

This implies that an oligopolistic market is characterized by a certain degree of price rigidity or stability, especially when there is a change in prices in downward direction. For example, if an organization under oligopoly reduces price of products, the competitor organizations would also follow it and neutralize the expected gain from the price reduction.

On the other hand, if the organization increases the price, the competitor organizations would also cut down their prices. In such a case, the organization that has raised its prices would lose some part of its market share.

The kinked demand curve model seeks to explain the reason of price rigidity under oligopolistic market situations. Therefore, to understand the kinked demand curve model, it is important to note the reactions of rival organizations on the price changes made by respective oligopolistic organizations.

There can be two possible reactions of rival organizations when there are changes in the price of a particular oligopolistic organization. The rival organizations would either follow price cuts, but not price hikes or they may not follow changes in prices at all.

A kinked demand curve represents the behavior pattern of oligopolistic organizations in which rival organizations lower down the prices to secure their market share, but restrict an increase in the prices.

Following are the assumption of a kinked demand curve:

- i. Assumes that if one oligopolistic organization reduces the prices, then other organizations would also cut their prices

- ii. Assumes that if one oligopolistic organization increases the prices, then other organizations would not follow increase in prices
- iii. Assumes that there is always a prevailing price

A kinked demand curve model is explained with the help of Figure-2:

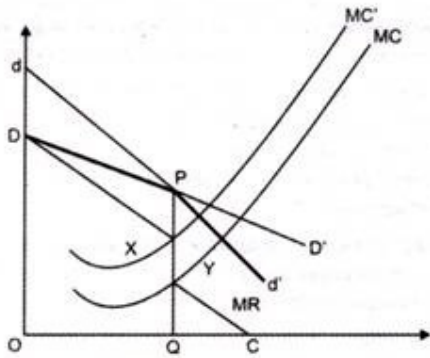


Figure-2: Kinked Demand Curve Model

The slope of a kinked demand curve differs in different conditions, such as price increase and price decrease. In this model, every organization faces two demand curves. In case of high prices, an oligopolistic organization faces highly elastic demand curve, which is dd' in Figure-2.

On the other hand, in case of low prices, the oligopolistic organization faces inelastic demand curve, which is DD' (Figure-2). Suppose the prevailing price of a product is PQ , as shown in Figure-2. If one of the oligopolistic organizations makes changes in its prices, then there can be three reactions of rival organizations.

Firstly, when the oligopolistic organization would increase its prices, its demand curve would shift to dd' from DD' . In such a case, consumers would switch to rivals, which would lead to fall in the sales of the oligopolistic organization. In addition, the dP portion of dd' would be more elastic, which lies above the prevailing price.

On the other hand, if price falls, the rivals would also reduce their prices, thus, the sales of the oligopolistic organization would be less. In such a case, the demand curve faced by the oligopolistic organization is PD' , which lies below the prevailing price.

Secondly, rival organizations will not react with respect to changes in the price of the oligopolistic organization. In such a case, the oligopolistic organization would face DD' demand curve.

Thirdly, the rival organizations may follow price cut, but not price hike. If the oligopolistic organization increases the price and rivals do not follow it, then consumers may switch to rivals. Thus, the rivals would gain control over the market. Thus, the oligopolistic organization would be forced from dP demand curve to DP demand curve, so that it can prevent losing its customers.

This would result in producing the kinked demand curve. On the other hand, if the oligopolistic organization reduces the price, the rival organizations would also reduce prices for securing their customers. Here, the relevant demand curve is Pd' . The two parts of the demand curve are DP and Pd' , which is DPd' with a kink at point P .

Let us draw the MR curve of the oligopolistic organization. The MR curve would take the discontinuous shape, which is $DXYC$, where DX and YC correspond directly to DP and Pd' segments of the kinked demand curve. The equilibrium point is attained when $MR = MC$. In Figure-2, the MC curve intersects MR at point Y where at output OQ .

At point Y , the organization would achieve maximum profit. Now, if cost increases, the MC curve would move upwards to MC . In such a case, the oligopolistic organization cannot increase the prices. This is because if the organization would increase the prices, the rival organizations would decrease their prices and gain the market share. Moreover, the profits would remain same between point X and Y . Thus, there is no motivation for increasing or decreasing prices. Therefore, price and output would remain stable.

However, kinked demand curve model is criticized by various economists.

Some of the major points of criticism are as follows:

- i. Lays emphasis on price rigidity, but does not explain price itself.
- ii. Assumes that rival organizations only follow price decrease, which does not hold true empirically.
- iii. Ignores non-price competition among organizations. Non-price competition can be in terms of product differentiation, advertising, and other tools used by organizations to promote their sales.
- iv. Ignores the application of price leadership and cartels, which account for larger share of the oligopolistic market.

c. Discuss theory of innovational profit.

Ans: Schumpeter's Innovation Theory of Profit:

Definition: The **Innovation Theory of Profit** was proposed by Joseph. A. Schumpeter, who believed that an entrepreneur can earn economic profits by introducing **successful innovations**.

In other words, innovation theory of profit posits that the main function of an entrepreneur is to introduce innovations and the profit in the form of reward is given for his performance. According to Schumpeter, **innovation** refers to any new policy that an entrepreneur undertakes to **reduce the overall cost of production or increase the demand for his products**.

Thus, innovation can be classified into two categories; The **first category** includes all those activities which reduce the overall cost of production such as the introduction of a new method or technique of production, the introduction of new machinery, innovative methods of organizing the industry, etc.

The **second category** of innovation includes all such activities which increase the demand for a product. Such as the introduction of a new commodity or new quality goods, the emergence or opening of a new market, finding new sources of raw material, a new variety or a design of the product, etc.

The innovation theory of profit posits that the **entrepreneur gains profit** if his innovation is successful either in reducing the overall cost of production or increasing the demand for his product. Often, the profits earned are for a shorter duration as the competitors imitate the innovation, thereby ceasing the innovation to be new or novice. Earlier, the entrepreneur was enjoying a monopoly position in the market as innovation was confined to himself and was earning larger profits. But after some time, with the others imitating the innovation, the profits started disappearing.

An entrepreneur can earn **larger profits for a longer duration** if the law allows him to patent his innovation. Such as a design of a product is patented to discourage others to imitate it. Over the time, the supply of factors remaining the same, the factor prices tend to rise as a result of which the cost of production also increases. On the other hand, with the firms adopting innovations the supply of good and services increases and their prices fall. Thus, on one hand the **output per unit cost increases** while on the other hand the **per unit revenue decreases**.

There is a point of time when the difference between the costs and receipts gets disappear. Thus, the profit in excess of the normal profit disappears. This innovation process continues and also the profits continue to appear or disappear.

