

# Price leadership

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There are 2 versions of the kinked demand curve model, one is called the Sweezy Version and the other is called the Hall and Hitch Version. Sweezy's model is based on the marginalist approach, with the hypothesis that even an oligopolistic firm aims at profit maximisation. In contrast, the Hall and Hitch version rejects the marginalist approach of profit maximisation. It argues that, under oligopoly, firms aim at 'fair' profit and follow the full cost principle in determining the price. Sweezy's Model of Kinked Demand Curve

According to Sweezy, the most distinguishing feature of oligopoly is that an individual firm does not know and cannot determine the exact nature of its demand curve because of the uncertainty and indeterminacy of rivals' reactions to its own actions. Under oligopoly a firm expects that when it raises its price, it is most likely that rival firms will not follow the suit by raising their prices. The rivals will keep their prices constant in order to increase their sales at the expense of the firm that raises the price.

That is, for upward changes in price, a firm's demand is expected to be highly elastic, in contrast when the firm lowers its price, it is most likely that its rivals will follow suit because if they do not do so they would lose sales to the firm that lowered the price. Consequently, for an oligopolistic firm, the demand curve is highly elastic and gradually falling for prices above the current or existing prices, and for prices below the current price the demand curve is less elastic and steeply falling.

Thus the most important conclusion of Sweezy's Kinked Demand curve model of oligopoly is that price remains unchanged and rigid or 'sticky' at the existing level  $P$  when, in the short run, the marginal cost increases due to a

rise in raw material prices or hike in wages through trade union pressure. Thus it explains the rigidity or stickiness oligopolistic prices in the face of short-term increases or decreases in variable input costs. When costs of raw material or labor rise, profits will get squeezed and when these costs fall the benefit of lower input costs will not be passed on to the consumers.

The principal shortcoming of the Sweezy model is that it does not explain how the existing or current price is determined and this is a criticism that Sweezy accepts. Hall and Hitch version of Kinked Demand Curve The hall and hitch model is based on an empirical Survey of a sample of 38 well managed firms in England. The principal findings of the study were as follows: a. In the real world, most manufacturing firms operate in oligopolistic markets. b. Most of the firms tend to be multi-product firm they also do not know the marginal cost curve. c.

Oligopolistic firm in reality determine their price on the basis of Full Cost principle. They charge that price which not only covers variable and fixed cost but also yields a fair profit margin. Full Cost = AVC + AFC + Fair Profits as a percentage of (AFC + AVC) The demand curve has a kink at the price which is equal to Full Cost Price. d. Oligopolistic firm adopt Full cost pricing rule because it not only covers AFC at normal output but also earns a reasonable rate of profit. The objective of oligopolistic firms is to have long run stable profit and a quiet life free from uncertainties.

Thus unlike the Sweezy version, this version explains how the existing price is determined. Objective of Sales Maximisation with Profit Constraint

According to William Baumol, the objective of the top management of a large

joint stock company operating in an oligopolistic industry is to maximise sales revenue with a (minimum) profit constraint. This is because the interest of the top management in the form of salary, prestige, staff expenditure, etc are closely and directly related to the monetary value of the sales (turnover) of the company.

However, the job security of the management is related to the threat of takeover which, in turn, depends upon whether the company earns the minimum profit necessary to keep shareholders satisfied. Thus, the oligopolistic joint-stock company decides its output or price to attain the objective of maximizing sales with a profit constraint. This is illustrated by Figure. Diagrammatic representation of situation: In Fig. Curve TR shows variations in the money value of sales (price multiplied by output) and curve TC shows variations in total costs as output changes and slope TR shows the Marginal Revenue and slope of TC shows the marginal cost.

TR and TC intersect at points M and N and so profits are zero at the corresponding outputs F and G. The tangent to TR at point R1 is parallel to the tangent to TC at point C. Hence at these point the slopes of TR and TC, showing marginal revenue and marginal costs are equal. At the points the vertical distance between TR and TC measuring profits is at the maximum. Thus profits are maximised at output Q1 corresponding to points R1 and C. here maximum profits are maximised profit are Q1A on the curve FAG showing variations in profit with output. TR is highest at point R3 where the marginal revenue is zero.

Here sales are maximised regardless of the profit level. Corresponding to R3 is output Q3 which shows sales maximisation without profit constraint. If the firm is interested only in maximizing sales without profit constraint. If the firm is interested only in maximising in sales without any concern about earning a certain minimum profit, then the curve FAG shows that at output Q3 it would earn profits + Q3 D. Here at end we can state that its up to Management to decide whether to go for Profit maximisation or for Sales Maximations in Long Run. Joint Profits Maximisation Model

Under Oligopoly, each firm may find that in the long run, instead of pursuing the goal of maximisation of its own profits, its advantageous to work towards the goal of maximization of the joint (Combined) profits of the industry. From the individual firms marginal cost curves, the combined MC for the industry is derived through a horizontal summation of the MCs of individual firms. Since the industry demand curve is known, we derive from it the industry marginal revenue curve. The point at which the Combined MC cuts the The industry MR curve from below gives the industry equilibrium output where the joint profits are maximised.

The price on the industry demand curve for this output is the common price that is charged by each individual oligopolistic firm. Figure, explains the determination of an industry's common equilibrium price at which joint profit are maximised as well as individual oligopolistic firms output and profits. But by adopting the objective of maximization of joint profits, the colluding oligopoly firms are forgoing independence of behaviour in return for certainty of price and stability of profits.