

# The main economic features of an oligopoly economics essay

[Economics](#)



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## **INTRODUCTION of MICROECONOMICS ASSIGNMENT**

This first report aims to analyze the both parts of questions two based on microeconomics aspects. The contents of the report are structured as following sections, after a brief introduction, the first part of report will discuss the main economic features of oligopoly, and key economic theories of price fixing. The next part examines the civil aviation aircraft manufacturing industry, analyzing the entry barriers protecting Boeing and EADS (Airbus), how they compete with one another, and what opportunities for collusions they have.

### **(A)**

Identify the main economic features of an oligopoly and explain the key economic theories of price fixing.

### **The Main Economic Features of an Oligopoly**

An oligopoly is a common market form in which a market condition exists when the market dominated by a small number of suppliers, and it often referred as highly concentrated industries (Begg & Ward, 2009). According to Sanjiv Mahajan (2006), he suggests that oligopoly is an industry or market in which the top four businesses have 40 percentages point of concentration ratio, which the four-firm concentration ratio is one of the commonly used tools for measuring the total market shares of the four largest firms in an industry (Wikipedia, 2013). It means oligopoly firms have more than 40% of the market share. Examples of oligopoly firms are aerospace, supermarket, brewing, and tobacco industries as shown in Table below. Table : Examples

of Industries that have an oligopolistic market structures (Mahajan, 2006) Oil Shell, Exxon Mobil, BP Groceries/Food Retail Tesco, Asda, Sainsbury, Morrisons Brewers Carlsberg, Guinness, Interbrew, Scottish and Newcastle Banks Barclays, HSBC, Lloyds TSB Postal Services Royal Mail Airlines British Airways, Boeing Pharmaceuticals GlaxoSmithKline, Astra-Zeneca Soft Drinks Coca Cola The next characteristic of oligopoly is that each firm in the market is produced similar but not identical products (Bradford University School Of Management, 2012). Firms operating in oligopoly market attempt to differentiate their products and advertising to improve sales and maintain price differences (Encyclopedia of Business, 2nd ed., 2013). Examples are the automobile industry and cigarette industry. Another characteristic of oligopoly firms is the high entry barriers or obstacle for a firm's to enter industry thus its limit the number of players in the market (Begg & Ward, 2009). According to Acs and Audretsch (1998), " while there is ambiguity between the pattern of entry for large firms or all firms sizes and capital intensity, small-form entry would be expected to be impeded in the presence of high capital barriers". This implies that it perfectly normal have multiple sources of barriers, but the level of essential costs to start-up new firm might outside of the firm's control. Another entry barrier is the government regulation that favoring numbers of players in market hence making new player difficult or impossible to enter. Example is the operation of Singapore casino-based vacation resort has limited to two licenses that have been awarded to Marina Bay Sands and Resorts World Sentosa in 2010 (Wikipedia, 2012). There is non-price competition feature in oligopoly market. Each of oligopolists has controls over the supply in a market and all

firm's output can be easily monitored. This means the decisions of one firm will influence, and be influenced by the decisions of other rival firms; hence oligopolist will always consider the likely reaction of competitors when making decisions (Begg & Ward, 2009). The Kinked demand curve model shown in the figure below suggests that prices will be rigid in oligopoly. If firms increase its price then they will lose relatively large market share, demand is elastic for price increase; on the contrary, if firms reduce price likely competitors follow suit and only marginal increase in market share, demand is inelastic for price reduce. Figure : Oligopoly Market - Kinked demand curves (Begg & Ward, 2009)

## **The Key Economic Theories of Price Fixing**

Based on the observed from figure above, firms in oligopoly market would not wish to engage in price competition. However firms may decide to engage in price fixing agreement during some financial situations. Example of the situations would be when the firms seek to maximize profit, or reduce market risk and uncertainty, the oligopolists will involve in some form of collusive activities such as co-operate with each other and act as monopoly (Begg & Ward, 2009). The formal agreement among competing firms to increase profits by reducing competition is known as cartel agreement, the agreement may include price fixing, total industry output, and bid rigging (Wikipedia, 2013). The example of price fixing is oil price-fixing that starts with the OPEC (Organization of Petroleum Exporting Countries) and the large companies like Exxon Mobil and BP (Lindorff, 2005). Price fixing usually indicates an attempt by sellers to exert influence and control over supply in the market, and then fix the price at a level that close to the monopoly.

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Under profit maximization  $MR = MC$ , when both MC (marginal cost) and MR (marginal revenue) are positive, a producer cartel firms may reduce the prices to increase sales and made a positive contribution to total revenue (Begg & Ward, 2009). The illustrated figure 2 below can see that the demand is price elastic and reducing prices could generate greater revenues. Figure : Collusion versus Competition (Begg & Ward, 2009) However price fixing may break down. The collusion is likely to fail when there is problem within a collusive agreement between suppliers. The co-ordination and enforcement of price fixing agreement might be too complex to control and firms could blame each other for cheating (Begg & Ward, 2009). According to Fershtman and Pakes (2000), they suggest that " if one of the firms gets good realizations of its investment efforts it may demand some changes in the collusive agreement, Changes that would reflect their new superior position. The demand for such changes may be accompanied by a threat of price war". This implies that any one firm expanding output or increase price slightly could achieve extra profits. However if one firm is success in doing this, then any member of the cartel could recognized it and do exactly the same. Once the cartel agreement breaks down, the results will be a severe threat of price way, possibly fall in price and excess supply in the market. It might also due to market regulators involve in collusive agreement, fall of market demand, and entry of new big player.

## **QUESTION 2 (B)**

Examine the civil aviation aircraft manufacturing industry, analyzing the entry barriers protecting Boeing and EADS (Airbus); how they compete with one another; and what opportunities for collusion they have.

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## **Examine the Civil Aviation Aircraft Manufacturing Industry**

Civil aviation aircraft manufacturing industry is the highly concentrated and high technology manufacturer that is involved in the various industry sectors of developing, making, testing, selling, servicing, and maintaining of civil aircraft (Wikipedia, 2013). The industry is one of the largest industries in the worlds which Airbus and Boeing are the top two firms who dominate the worlds market (Boeing, 2012) (Airbus, 2013) (AviationKnowledge, 2010). The specialized agency, International Civil Aviation Organization (ICAO) was created in 1994 to promote common standards and recommend regulations necessary for civil aviation such as safety, efficiency and environmental protection among 191 members from most of the countries (International Civil Aviation Organization, 2011). The illustrated industry value chain below help by giving a better picture of the position for aircraft manufacturing in the industry: Figure : Illustration of Aircraft Value Chain

Air travel is a large and growing industry in the worlds, which the world travel demand for air travel is still remains high in spite of slowness in global economy (Money, 2012), and the industry has a positive healthy growth rate by world tourism rankings from the top 10 international tourism destinations in 2011 (Wikipedia, 2013). This implies that the aircraft market demand is remains high and affirmative outlook. Looking at 2011 financial report of Airbus (EADS, European Aeronautic Defense and Space) and Boeing, both companies have reported growth in sales revenues and good net income in 2011 compared to previous year as shown in the following chart. The two charts shows that Bombardier as a third player in the market able to achieve comparable net income. Chart : Total Revenues of Airbus (EADS), Boeing, <https://assignbuster.com/the-main-economic-features-of-an-oligopoly-economics-essay/>

Bombardier - Currency in EUR millions and conversion EUR= 1.33147USD - (Boeing, 2011) (EADS, 2011) (Businessweek, 2013) Chart : Net Income of Airbus (EADS), Boeing, Bombardier - Currency in EUR millions and conversion EUR= 1.33147USD - (Boeing, 2011) (EADS, 2011) (Businessweek, 2013) Apparently, this is an attractive industry and it would naturally attract new player's attempts to enter the market. It is perfectly normal that there are new entrants or smaller players in the market; however the firms might not start-up or sustainable if fail to overcome the entry barriers, or the revenue is too small unable to impact the market share and price. Example would be China has delayed their regional jet ARJ21 due to failure to receive China aviation regulatory approval, and this has weakened the threat to Boeing and Airbus Duopoly (Wang, 2011). The following section will look at the entry barriers protecting Boeing and EADS (Airbus).

### **Entry Barriers Protecting Boeing and EADS (Airbus)**

The most notable entry barriers protecting Boeing and Airbus would be the technological barriers. The safety is a highest concern for civil aircraft, buyers would demand an advanced technological in developing aircraft, under relative stringent safety measurement by aviation regulation. And there is high level of risk that the research and technology might fail, this would bring a serious financial lost for the firms whom developed it (Esposito, June 2004). Hence, the threat of substitute products and new technological in the aircraft market is weak. The next major entry barrier is financial barriers. The development costs to launch of new aircraft are a big amount. According to Emilio Esposito (2004), suggests that " manufacturing firms must deal with not only technological barriers but also notable financial

barriers". Consider the development costs for Jumbo Airbus A380 was estimated at 12 billion (euro), this would requires an effective pricing strategy and longer time for Airbus to break even (Begg & Ward, 2009).

### **How they compete with one another**

Airbus and Boeing have possessed a duopoly competition in the global market for last jet airliners since 1990s, which is a result of mergers within the global aerospace industry over the years (Wikipedia, 2013). The duopoly is used to define an oligopoly situation where only two players have dominant over one market. Both aircraft manufacturers compete in several areas. One of the areas is government subsidies that help manufacturers afford to spend and develop new technologies. The example is Boeing and Airbus have regularly accuses other receiving unfair state aid from governments (Wheeldon, 2007) (DREW, 2010). Another example would be U. S. and EU claim victory in Boeing subsidy case which Boeing received \$3 billion in illegal U. S. subsidies over a period of eight years (Rooney, 2012). Others competition lists are competition through provision of engine choices, competition by outsourcing, and competition through use of technology (Irwin & Pavcnika, December 2004) (Wikipedia, 2013).

### **What opportunities for collusion they have**

The duopoly competition in aircraft manufactures has creates an attractive opportunity and it is easy for two firms to co-ordination and enforcement of cartel agreement. However aircraft is a large industry and it is easy to bring world's regulators attention. Example would be Boeing and Airbus are targets of U. S. and European Union regulators for Price-Fixing probe in 1998



(Bloomberg News, 1998). Aircraft manufacturer is a market form of oligopoly, this implies when the two aircraft manufacturers making decision they have to consider whether there is possible of the cartel agreement breaks down. It could lead to a threat of price war, which possibly impact company revenues and fall in price. Example would be Airbus and Boeing reported locked in global price war in 2012 (Reuters, 2012).(1749 words for both questions; not including heading, diagrams, tables, footnotes and references)(References/bibliography on the last page)

## **ASSESSMENT TWO: MACROECONOMICS (1750 words)**

The second report is based on the first question from a selection of two.

### **SUMMARY of MACROECONOMICS ASSIGNMENT**

This second report examines the both parts of questions based on macroeconomics aspects. The contents of the report are structured as following sections, after a brief summary, the first part of report outlines the fiscal policy, why do fiscal deficits and increases in government debt occur. The next part will discuss why some governments experienced sovereign debt crises, and to what extent might efforts to reduce government debt risk creating double-dip recessions.

### **QUESTION 1 (A)**

What is fiscal policy; and why do fiscal deficits and increases in government debt occur?

## What is Fiscal Policy

In macroeconomics, governments have three economy policy tools can use to control and monitor national economy, which are fiscal policy, monetary policy, and direct controls (Wikipedia, 2013) (Bradford University School Of Management, 2012). The following sections will examines what is a fiscal policy and aggregate demand, weakness of fiscal policy, and fiscal policy transmission mechanism. The fiscal policy is the mixture choice of strategy to monetary policy for government, which monetary policy is the use of money supply and changing interest rates in the economy that curb inflation. On the contrary, fiscal policy is the government spending policies that made changes in government spending and tax rates. The government spending could be funded in the following ways: taxation, print money, borrowing, consumption of fiscal reserves, and sale of fixed assets such as land. The instruments of fiscal policy are the change in the level of taxation and government spending that will influence aggregate demand, equilibrium level of output, long-run growth in real GDP, income distribution, equilibrium level of output, and increases employment (Begg & Ward, 2009) (Bradford University School Of Management, 2012). Examples of government spending would be government spending on transport, health, and education. Good use of fiscal policy would enable government to quick fix the macroeconomics issues in country, however there are several known implementation weaknesses need for government consideration in making decision. Example of weaknesses is the problem of predicting when economy has changed or stability has recovered automatically, hence there is no need for the government to continue make policy change. It also may due to the

problems of timing (time lags between recognition and action), uncertainty, and offsetting changes (Begg & Ward, 2009). In order to overcome these problems, government have to actively manage the fiscal policy, which requires timely and accurate information of the change of aggregate demand, and the change of economy condition, then made respective adjustment promptly. Fiscal policy transmission mechanism consists of two major policies which are expansionary policy and Contractionary policy. Expansionary fiscal policy is focus on these two major channels: reduce in taxation or increase government expenditures, decrease interest rates in the economy. Whereas Contractionary policy involves the following two channels: increase in taxation or reduce government expenditure, increase interest rates in the economy (Bradford University School Of Management, 2012). However, the use of expansionary fiscal policy would normally make the government fiscal deficit grow larger and this may lead to government fiscal stance.

## **Why do Fiscal Deficits and Increases in Government debt occur**

To help effectively interpret this question, the following sections will examine what is fiscal deficit, the effects of fiscal deficit and gross domestic product (GDP). When government is running fiscal deficit, it means there is annual differences between total government's expenditures and total tax revenue, which expenditures has exceeds tax receipts. Examples of the situations would be when economy recessions and slowed in growth (Begg & Ward, 2009). If deficits have opened up but absence of national cash reserves, government spending usually funded by borrowings through the issue of

debt such as bonds and national savings certificates. The lenders might include financial institutions such as private sectors, bank, ordinary households, and overseas investors. The effect of this policy is growing in national debt, the total accumulated debt owned by the government. Hence these increases in Government debt occur. The deficit can be measure by percentage of GDP. In economic, the way to examine level of borrowing is by comparing external debt to gross domestic product, which the external debt is the measure of a total debt in a country that is owned to foreign creditors (Toscano, 2012). The following chart from CNBC indicates the world's top 20 debtor nations based on external debt-to-GDP ratio. Chart : World's Biggest Debtor Nation 2012 (Toscano, 2012) CNBC March 2012 From the previous chart can see that there are large national debts from most countries. This implies that there is a large fiscal stimulus by the government to help stimulate the economy. However, a persistently large budget deficit naturally could lead to other financial problems. Example of the problems would be the fiscal crowding-out happens when slow national growth in private sectors consumption and investment spending, which is due to government spending has absorbs economic resource, higher interest rates and taxation. The next problem is the total amount of unpaid government debt will continue climbing and this represent a serious undesired side effect to opportunity cost because the interest payments on bonds might have use in more productive ways. Another major concern to the policy is the large country budget deficit may not sustainable. Example would be the warning of U. S. budget deficit is not sustainable in the long run (Foley, 2010) (Arestis, et al., 2004). Also according to Marc Labonte (2012), " Budget

deficits have reached historically high and unsustainable levels since 2009 because spending has been at its highest share of GDP since 1945 and revenues have reached their lowest share of GDP since 1950" (Labonte, 2012 ).

## **QUESTION 1 (B)**

Why have some governments experienced sovereign debt crises; and to what extent might efforts to reduce government debt risk creating double-dip recessions?

### **Why Have Some Governments Experienced Sovereign Debt Crises**

In order to elaborate why some governments have experienced sovereign debt crises, the following sections will look briefly sovereign default and sovereign debt crisis. What is a sovereign default and sovereign debt crisis? We know that the accumulation of government annual fiscal deficits is growing in government debt occur, this also can be defined as a sovereign debt which is a government debt owed to its creditors. The growing and persistency of public debt will increase public concerns whether the government debt has above a threshold and affect economic growth. Then creditors naturally will suspect whether government is unable or not willing on the debt or interest payment. So creditors will demand for higher interest rates (higher return) to offset their risk, this results in government have to borrow at more expensive rates to refinance to pay off its older debt, hence this worsen the sovereign debt (Caner, et al., 2010). When the sovereign debt has reached a high level and country stuck in bad sovereign debt situations, governments normally do sovereign default which is a failure or <https://assignbuster.com/the-main-economic-features-of-an-oligopoly-economics-essay/>

refusal of the government to pay back its debt. The consequence of sovereign default is a sovereign debt crisis, which is a situation when a government unable to pay its sovereign debt, then there rises in national interest rate and drop in country credit rating (Wikipedia, 2013). Example of crises is the ongoing European sovereign-debt crisis that some countries in euro not able or difficult to repay their government debt and need assistance from other parties. It is clearly now that governments will experience sovereign debt crises when government spending above its limit and not willing or unable to pay back (BBC News, 2012). Second, the rise of prices and wages due to inflation and then tax revenues fell (Krugman, 2011). Other reasons could be high unemployment rate, decline of consumer purchasing power, and the failure of government measurements in dealing with the deep economic crisis (Sydney Morning Herald, 2012 ) (OECD calculations, 2011) .

### **To what extent might efforts to reduce government debt risk creating double-dip recessions**

The following sections will examine briefly what is double-dip recession, and then what are the possible strategies for government to reduce government debt risk creating double-dip recessions. What is a double-dip recessions?

First thing to understand, if country credit rating is down, interest rates will arise across the board, a credit card, car loan, adjustable mortgage all will be pay more. It means that when government needs to pay more, there is a significant impact to public which they have to pay more too or become unaffordable. So when there is a large scale of country sovereign default, or recession, one way the public could do is convert their loan from adjustable

finance to fixed rate, but this would have increased risks of threat to social unrest and lead to political instability. (Kim, 2011). During recession, the sovereign debt might reach high level; government will generally reduce spending, reduce services, and raise taxes. The aggressive government cutbacks and tightening of fiscal policy will shrink the countries deficit a percentage point of GDP, the negative effect would be the increase odds of double-dip recession. The first example is U. S. chance of double-dip recession in 2010 will rise to one in three from one in four if U. S. congress unable to extend unemployment benefits and provide federal aid as U. S. president Barack Obama requested, because U. S. GDP ratio was expected to reduce by 1.3 percentage points after the Obama \$787 billion stimulus program expires (Miller & Kenned, 2010) (Hao Li, 2012). Another example is UK economy falls into double-dip recession in 2012 (Bulent Gokay, 2012). The first option could be money printing that England and U. S. are doing to reduce the impacts of recession by buying back its treasury debt in order to stimulate economy growth. However the policy might cause the euros and dollar to decline that will lead to inflation. It would also will impact others countries foreign reserves that in euros or dollar currencies, and possibly of worldwide economy depression (Ambrose Evans-Pritchard, 2009) (Jennifer, 2012). Alternatively, the print more money policy to beat double-dip recessions might restructure and use in other areas such as investment that having better return (Lambert, 2012). Next option is governments find a fair and sustainable ways lead to economic growth to reduce the risk creating double-dip recessions, which countries GDP is growing faster than the increase in government debt hence budget deficits would automatically heal.

However governments have been warned that the more government spending will just make the financial crisis worse (Fisher, 2010), and double dip recession in UK has proved austerity doesn't work (Cohen, 2012). Also, the return to growth of economy can be too weak for countries having high level of sovereign debt and high interest rates (Thomas & Jolly, 2012). Another option is governments may seek for bail-out package, but it might help the countries for a period of times only then will require another official bailout if the root causes of sovereign debt are remain unresolved (Roubini, 2011). Apparently, the most importance is governments have to look into the root causes of recession. A realistic and drastic restructure of government policies, administrators process, or structural changes to deal with the root causes (Gokay, 2012). (1748 words; not including heading, diagrams, tables, footnotes and references) (References/bibliography on the last page)

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