Kinked demand curve essay

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Critically examine the proposition that the relative stability of prices in an oligopolistic market is adequately explained by the Kinked-demand curve analysis. What other theories have been developed to explain this phenomenon?

Introduction – 150

Oligopolistic Market – 400

It can be argued that the most important theories of the firm is the theory of oligopoly. There are few industries within the European Union and the United States of America that are imperfectly and monopolistically competitive consisting of many firms. However, the majority of existing industries are oligopolistic where very few firms operate share a large proportion of the industry (Anderton 2001).

Characteristics of firms in the industry are:

- Significant barriers to entry restricting the entrance of new firms into the market. These barriers differ from industry to industry and are similar to those under monopoly.
- Interdependence between firms. Firms are mutually dependent due to the fact that each firm will have to take account of others as a result of very few firms operating in the industry. The sales of a rival firm will be affected by the decision a firm to alter specifications or prices of a product. Prices and specifications may be changed as a response by rivals. Thus, each firm is affected by the actions of rivals (Sloman and Sutcliffe 2004).
- Few firms must determine the supply within the industry. An example would be an industry where four firms produce 85 per cent of output

even though the industry may consist of 96 smaller firms. This type of industry would still be classified as oligopolistic.

Even though there are crucial features that distinguish oligopoly from other market structures, differences still exist between firms. Even though firms may be producing virtually homogenous goods, these products are still differentiated as is the case with cars and soap powders. Much of the competition between oligopolies relies on elements of a marketing mix rather than solely concentrating on price summarised as the ‘ 4 Ps’ (Anderton 2001).

The ‘ 4 Ps’ refer to:

• Products a firms produces which appeals to customers,

• Price a firms will set depending on the pricing strategy implemented by the firm,

• Promotion such as advertising creating awareness to buyers of goods currently on sale and,

• The Place the good will be distributed making it easy access for customers.

To reduce the uncertainty of profits firms may result to collusion enabling them to maximise profits. Formal agreements between firms involving collusion are known as cartels. Big penalties are dished out in many European and US industries due to the formation of cartels being outlawed.

Kinked Demand Curve

A Kinked Demand Curve theory was developed in 1939 of non-collusive oligopoly. This theory is used to explain price stability in an oligopolistic market. The model developed by Paul Sweezy, R. L. Hall and C. J. Hitch seeks

to explain how prices remain stable even when there is no collusion between oligopolies.

An assumption of the Kinked Demand Curve theory is that an oligopolistic firm will face two demand curves as a result of a kink. The point of the kink is the established market price within the industry. The demand curve comprises of two segments as a result of this kink. The first segment relates to the increase in price by a firm resulting in the demand curve being relatively more elastic, whereas, the second segment relates to a firm decreasing its price resulting in a less elastic curve (Webmaster 2009).

The theory assumes a change in price by one firm will lead to two asymmetrical reactions. The first being when firm A reduces its price, other firms in the industry will either maintain or cut its prices due to a fear of losing customers or sales to the first firm.

The firm’s agenda to decrease price can be further represented by Figure 1. 2. At the industry price Pe, a decrease to price P2 will lead to an output from Qe to Q2 along the inelastic AR= D curve. This will leave the firm making a loss in Total Revenue (TR). The advocacy in price stability is due to the shaded blue area representing a loss in TR being greater than the shaded grey area representing a gain in TR. This is mainly down to the inelastic demand curve AR= D, where a percentage change in price leads to a relatively smaller responsive change in quantity demanded.

The second being when an oligopolistic firm raises its price, its competitors will not be induced to follow suit, leaving them to gain market share. The firm’s agenda to increase price can be further represented by Figure 1. 3

below. At the industry price Pe, an increase to price P1 will result in an output for the firm from Qe to Q1 along the elastic AR= D demand curve. Due to the shaded blue area representing a loss in TR being greater than the grey area representing a gain in TR, the firm will be trading at a loss. This again encourages price stability for goods in an oligopolistic market. This TR loss is down to a relatively elastic demand curve AR= D, where a percentage change in price leads to a greater responsive change in quantity demanded. The stability in price in an oligopoly market leads to firms trying to obtain a greater share of the market via non-price competition.

Game Theory – 500

Prisoners Dilemma 200

Conclusion – 150

Even though it is clear the Kinked Demand Curve points out there will be price stability in an oligopolistic market, there is no mention of other factors that may fluctuate prices. The Kinked Demand Curve theory does not give any indication as to the reasons why prices are set.

Factors included in the ‘ 4 Ps’ are very influential in an oligopolistic market. Oligopolists will be more inclined to pour supernormal profits into the research and development department than that belonging to a monopoly. This will be to aid the value of a product by increasing design, improving efficiency or by technological improvements.

The place of the product can also have an impact on price. An airline company may have unique access to a geographical location of a country enabling the firm to operate almost as if they were a monopoly. Making the product conveniently available for consumers will give the firm strategic

advantages that will not be easily copied by competitors (Daniels, Radebaugh & Sullivan 2001).

Anderton (2001) advocates the need for the Kinked Demand Curve to aknowledge other factors than price. The main assumption of the theory is that firms will always react to other competitors changes in price but in reality the this is not the case.

REFERENCES

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