

# [Economies of scale](https://assignbuster.com/economies-of-scale/)

Economies of scale are the advantages in cost that a business gets due to expansion in the scale of production in the long-run. The effect of this is reduced average cost in unit output as the scale increases. This is a long run concept that refers to a reduced unit cost of production as the size of the company or scale of production increases. The economies of scale are not limited to any firm provided wants to increase its scale of operation. The lower average costs lead to an improvement in production efficiency which can trickle down to consumers through lower prices. It also gives a company competitive advantage in the market which leads to higher profits at low prices. Diseconomies of scale on the other hand refer to higher average costs as the firm’s scale increases leading to inefficiencies in production in the long-run.

The economies of scale are an important concept in international trade and global markets. It helps explain the number of firms in the market and those that mange to trade in international markets. A natural monopoly is a firm that has no competition and enjoys economies of scale at all firm sizes since it is more efficient for existing firms to expand than the formation of new firms. Natural monopolies enjoy market power which makes the publicly owned or regulated to avoid excessive exploitation of their economies of scale.

Economies of scale relates to returns to scale but can also be confused with this concept. While the economies of scale refer to the firm’s average costs, the returns to scale refers to the relationship between output an input in the long-run in the production function. Constant returns to scale occurs when inputs increase at a given proportion and the output increases by the same proportion. Decreasing returns to scale occurs when a increase in input is double the proportion of output achieved. Increased returns to scale occur when an increase in input results to double the increase in output. The contradiction of the theoretical notion of returns to scale and the practical concept of economies of scale is due to large fixed costs that are a source of economies of scale.

The common economies of scale include purchasing, managerial, financial, research and development, and marketing economies. Purchasing economies which include bulk buying of items through long term contracts. Managerial economies include specialization of managing personnel increasing in the long-run. Financial economies include obtaining lower interest charges when borrowing from financial institutions like banks and having greater access to greater financial instruments. Research and development economies include extensive research on products to be able to differentiate and improve the quality of products in the long-run. Marketing economies include spreading the costs of advertising over a greater range of agencies for quite a number of outputs in the media market. The effect of these economies is to reduce the long-run average costs of production.

Economies of scale can be achieved in two ways; a constant marginal cost and high fixed cost, and declining marginal cost and low or no fixed cost. In explanation economies has been referred to as decreased per unit cost with increasing output. The initial capital investment is spread over increasing number of outputs; this means that the marginal cost of producing a good or service is less than the average total cost per unit in an industry enjoying economies of scale. Economies of scale occur in industries with high costs of capital that can be distributed across many units of production. Exploitation in the economies of scale explains why some firms explain the growth of some firms in some industries. Free trade policies are essential in achieving larger markets since some economies of scale will require cross border markets to achieve efficiency. Due to fixed costs of production, initially the cost of production increase, and as the production volume increase, there is diminishing economies of scale.

The commercial banking industry in Kuwait has been in a position of overcoming the small scale constraints of the domestic markets and in the process has embraced the cost advantages of the economies of scale in the Gulf Region. The effects of these are the international investments and long term capital movements in the Gulf Region. This has been made possible by the liberal policies of foreign direct investment by the Gulf Cooperation Council this way freeing their economies other than the defensive protectionist policies that served to protect political affiliations. The council is made up of six member states that -Kuwait, Bahrain, Oman, Qatar, Saudi Arabia, and UAE. The countries are moving gradually towards market based economies through the liberalized trade and foreign direct Investment inflows (Borensztein, Gregorio, & Lee, 1998: 120).

Results from commercial banking show a positive relationship between liberalism and efficiency. The commercial banking industry in Kuwait might benefit from scale and technical economic efficiencies; technical efficiency due to modern technology hence and scale efficiency due to spread into other markets in the Gulf Region. These countries share similarities in oil production and export and Kuwait is the third largest of the six economies after Saudi Arabia and UAE. This means that they depend highly on the depletable oil resources thus there is need to diversify their economies which makes the financial sector most economically viable. The objective is to transform their economies into international trade and financial centers through improved efficiency and taking advantage of the economies of scale (Al-Obaidan, 2008: 95).

Commercial banking expansion by the Burgan Bank in Kuwait was a clear indication of the nature of expansion of scale economies in the banking industry. The bank announced an acquisition of holdings by the United Gulf Bank in Algeria, Jordan Kuwait Bank, Tunis International Bank and bank of Baghdad in 2008 in its regional expansion strategy making it one of the most geographically diversified banks. Through this expansion, the bank was able to achieve full service banking and instill its expertise in some of the strongest economies in the Middle East region. Consequently, the Gulf bank will be able to specialize on asset and investment banking while the Burgan Bank reaps profits that will lead to further growth and expansion of its economies of scale (Scitovsky, 1991: 150).

Multinational Corporations are increasingly being attracted to developing nations unlike in the past when they were only in developed nations. As a result, dealers in natural resources like Kuwait Oil industry has diversified their economies to international markets to draw close to consumers and control the supply chain. The Kuwait Petroleum Corporation (KPC) in 1981 held the foreign oil exploration interests and acquired Santa Fe, a US based oil drilling contractor. It also acquired the European oil refining and marketing interests in the Gulf region and the Danish Interests of the BP oil company.

It also introduced the OKQ8 in the Swedish fuel market and acquisition of BP network in the Netherlands and Automat networks. The Bp and Aral networks in Belgium were also acquired becoming the second largest fuel market player in Belgium. The focus on international expansion progressed with the acquisition of the Italian Mobil Company and AGIP at Milazzo. Airport refueling venture were also expanded in Europe and Hongkong. Today the KPI markets in Europe are over 300, 000 barrels of oil daily and over 90, 00barrels sold to over 4, 000 retail stations daily from its two refineries in Milazzo and Europort. Further global market expansion by KPC is towards the Far East nations. It is a most reliable energy supplier in the integrated Kuwait oil industry.

## Conclusion

The international markets are experiencing a global shift with change from the western orientation to the east especially the dynamic Asian economies (Stopford, 1998: 10). The more conservative Middle East countries with rigid trading blocs are increasingly becoming liberalized free market due to change of trade policies. Most notably is the expansion of the UAE and Kuwait economies after adopting free market policy. The markets therefore have been forced to cooperate as they compete instead of remaining rivals and rigid. Due to the economic interdependence now being experienced between nations, the countries are forced to diversify their scale of markets and production to meet the larger demand which can be met by increasing the economies of scale to global market.

International financial markets are increasingly causing market interdependence in the international trade. Inflationary pressures of strong currencies are some of the challenges of diversified international markets to achieve economies of scale especially in the recent global crisis. More liberal policies by European and American nations can also serve to increase revenue and demand of companies venturing into international markets. It is notable that economies of scale across nations can only be achieved if the liberal policies are adopted in the trading blocs (Junne, 2000: 100). Consequently these liberal policies will only serve their purpose if corporations take the cost advantages that come with economies of scale to expand their global markets and hence their profits.