Oligopoly

AEB 2104

Agricultural Economics

http://www.geocities.com/dsolisw/AEB2104.html

Characteristics Oligopoly

- Oligopolies are made up of a small number of mutually interdependent firms.
- Each firm must take into account the expected reaction of other firms.

Models of Oligopoly Behavior

- No single general model of oligopoly behavior exists.
- Two models of oligopoly behavior are:
  - the cartel model
  - the contestable market model.

The Cartel Model

- A ***cartel*** is a combination of firms that acts as it were a single firm.
- A cartel is a shared monopoly.
- In the cartel model, an oligopoly sets a monopoly price.

The Cartel Model

- If oligopolies can limit the entry of other firms and form a cartel, they can increase the profits going to the firms in the cartel.

The Cartel Model

- The ***cartel model of oligopoly***:
  - Oligopolies act as if they were monopolists,
  - That have assigned output quotas to individual member firms,
  - So that total output is consistent with joint profit maximization.

Implicit Price Collusion

- Formal collusion is illegal in the U.S. while informal collusion is permitted.
- ***Implicit price collusion*** exists when multiple firms make the same pricing decisions even though they have not consulted with one another.
- Sometimes the largest or most dominant firm takes the lead in setting prices and the others follow.

Cartels and Technological Change

- Cartels can be destroyed by an outsider with technological superiority.
- Thus, cartels with high profits will provide incentives for significant technological change.

The Contestable Market Model

- According to the ***contestable market model***, barriers to entry and barriers to exit determine a firm's price and output decisions.
  - Even if the industry contains only one firm, it could still be a competitive market if entry is open.
- In the contestable market model, an oligopoly with no barriers to entry sets a competitive price.

Examples of Contestable Markets

- Online Communications (including video conferencing; virtual reality games; publishing; home shopping; travel services; information services; databases)
- Home Banking and Financial Services
- Electricity and Gas Supply
- Parcel delivery
- Opticians
- Low cost domestic airlines

Comparing the Contestable Market and Cartel Models

- The stronger the ability of oligopolists to collude and prevent market entry, the closer it is to a monopolistic situation.
- The weaker the ability to collude is, the more competitive it is.
- Oligopoly markets lie between these two extremes.

Strategic Pricing and Oligopoly

- Both the cartel and contestable market models use ***strategic pricing decisions*** – firms set their price based on the expected reactions of other firms.

New Entry as a Limit on the Cartelization Strategy

- The threat from outside competition limits oligopolies from acting as a cartel.
- The newcomer may not want to cooperate with the other firms.

Price Wars

- Price wars are the result of strategic pricing decisions gone wild.
- Sometimes a firm engages in this activity because it hates its competitor.
- A firm may develop a predatory pricing strategy as a matter of policy.
- A ***predatory pricing strategy*** involves temporarily pushing the price down in order to drive a competitor out of business.