ECON 5103 Unit 8 Video 1

A Closer Look at Oligopoly

Chapter 9

Oligopoly is the dominant for of market structure in most modern developed economies
(Recall: In an oligopoly, a few large firms produce most of the output in the market.
Examples: Homes, autos, medical care, airlines, package sending.)

Strategic Decision-Making: Making decisions for the firm based in part on the expected of rivals.

Models of Oligopoly:

1. Cartel: The firms in the market collude, jointly deciding production levels and pricing. (Example: OPEC) (Example: DeBeers -- world's best marketing)

   No competition (almost as good as monopoly)

   Most cartels are illegal in the U.S. (exception: Major League Baseball)

2. Kinked Demand Curve:
(Intense competition among firms)

If 1 firm raises its prices, none of the other firms match the price hike.

If 1 firm lowers its price, all of the other firms match the price reduction.

3. Price Leadership
(Very little competition)

When the largest firm raises its prices, all of the other firms match the price increase.
This is almost as good as a cartel. It's sometimes called "tacit collusion"
Depending on the level of enforcement of antitrust laws, this may or may not be illegal.

Do profits exist in oligopolies?

Mainstream view: Yes. Because there are only a few firms in the market, there is not much competition so profits exist.
(Microchips, prescription drugs, software)

Alternative View

"**Theory of Contestable Markets**": Even though only a few firms exist NOW in a market, these firms know that if they keep prices too high to make big profits, then new entrepreneurs will enter the market and drive prices and profits down. (Example: auto industry)

Theory of Contestable Markets: In the long term, the mere of threat of future competition keeps companies from making huge profits and so prices must stay low.

Implication for firms: Keep innovating and keep prices low, or you will eventually fail.