SECTION 1

HIGHLY COMPETITIVE MARKETS

READ TO DISCOVER

1. What is perfect competition?
2. What is monopolistic competition?
3. How do sellers differentiate their products under monopolistic competition?

RESEARCHER CD-ROM

ECONOMICS DICTIONARY

perfect competition
buyers
sellers
monopoly
monopolistic competition
differentiate
product differentiation
nonprice competition

As a consumer, you tend to benefit most from competitive markets. These types of markets provide consumers with a range of products that are priced lower, reflect costs more accurately, and are offered by more sellers than in any other kind of market. The jeans market, for example, is highly competitive.

Why do highly competitive markets ensure such a large selection of goods and services? Supply and demand determine what items are produced and at what price they are available. The forces of supply and demand promote competition by encouraging producers to supply consumers with a wide selection of goods and services.

There are two types of highly competitive markets: those with perfect competition and those with monopolistic competition. Each is characterized by certain key conditions.

Perfect Competition

Perfect competition, also called pure competition, is an ideal market structure in which **buyers**, or consumers, and **sellers**, or producers, each compete directly and fully under the laws of supply and demand. This means that no one buyer or seller controls demand, supply, or prices. It also means that nothing prevents competition among both buyers and sellers.

How can you tell if a market is perfectly competitive? In general, perfect competition exists when four conditions are present:

- Many buyers and sellers act independently.
- Sellers offer identical products.
- Buyers are well informed about products.
- Sellers can enter or exit the market easily.

Many Buyers and Sellers When there are many buyers and sellers, each one accounts for only a small share of the overall purchases or sales in the market. Therefore, no single buyer or seller in a market has enough power to control

MARKETS & PRICES *Perfect competition enables buyers and sellers to compete under the laws of supply and demand.* ***What four conditions indicate perfect competition?***

demand, supply, or prices. Instead, levels of production and prices are set by the market forces of supply and demand.

Note that in perfect competition, the many buyers and sellers must act independently. Otherwise, a group of sellers or buyers acting together could influence—or even set—prices. Of course, when there are many sellers and buyers in a market, they are less able to act together to control prices. Having a large number of independent buyers and sellers thus promotes competition.

Identical Products Under perfect competition, sellers offer identical products, so buyers make purchasing decisions by comparing "apples to apples" rather than "apples to oranges." This means that buyers choose one product over another primarily on price, not on unique characteristics. Buyers' decisions thus give sellers accurate information about whether they are charging the best price for their products.

What would happen if buyers chose among nonidentical products? In this case, buyers' purchases would not be based on price alone, as in perfect competition. Each product's unique features would lead to a separate market, with a single firm providing that product to the market. This type of single-firm market is the basis for the market structure known as **monopoly**, in which one seller controls all production of a good or service. Monopolies will be discussed in greater detail in Section 2.

Informed Buyers Under perfect competition, buyers must be knowledgeable about products. Without accurate and readily available product information, buyers cannot compare products effectively. Sellers can compete perfectly only when buyers can make informed decisions.

Easy Market Entry and Exit For sellers to compete perfectly, they must be able to enter a profitable market—or leave an unprofitable one—easily. The freedom to switch from market to market helps ensure that a single seller or small group of sellers cannot dominate a particular market.

The ease of entering or exiting a market depends on start-up costs, the level of technical knowledge needed, and the amount of control held by existing companies in the market. If any of these factors—known as barriers to entry—are high, sellers cannot compete easily and fully.

Perfect Competition As a Model

Of course, no market is perfectly competitive. As noted above, perfect competition is a model of an ideal competitive market structure. This model helps economists analyze markets and determine how competitive they are. (See Figure 6.1.)

Some markets do approach perfect competition, however. One example is the agricultural

COMPETITION AND MARKET STRUCTURE

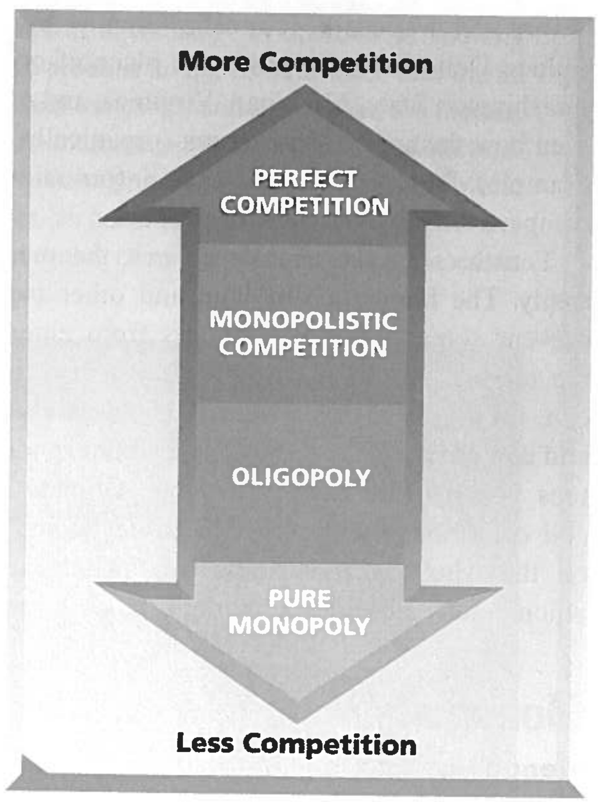


FIGURE 6.1 Market structure is largely determined by the amount of competition among producers. **Which market structure is the least competitive?**

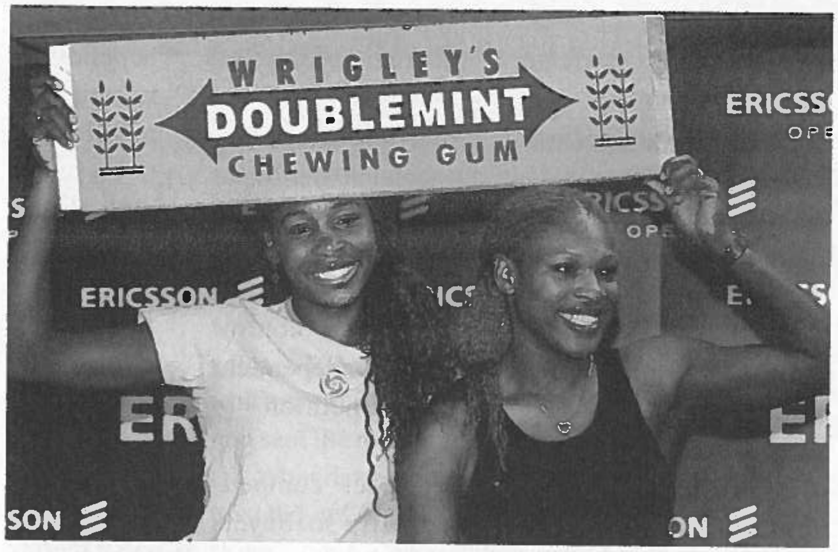
markets in the United States. Consider how well agricultural markets meet the four conditions of perfect competition.

First, many buyers and sellers act independently. Thousands of independent farmers and growers compete to sell their products to millions of buyers. No single buyer or seller controls enough of the market to affect the price of corn, peaches, or most other agricultural products.

Second, sellers offer identical products. Agricultural products are uniform: one apple is basically like another apple; one ear of corn is basically like another ear of corn. Buyers make their decisions based solely on the price of the apple or the corn, not on any distinguishing characteristics.

Third, buyers are well informed about the market's products. Labels on apples, for example, tell buyers the variety (McIntosh, Granny Smith, Golden Delicious), the price, the place of origin (Washington State, Michigan, Virginia), and often even how the apples were grown (organically, for example). Buyers can thus use this information to compare the price of identical products.

Fourth, sellers can enter or exit the market easily. The high price of land and other inputs prevent some potential suppliers from entering the market. But farmers who already own land can, for example, easily leave the carrot market and enter the tomato market if they believe tomatoes will become more profitable. Climate and soil conditions may restrict these decisions, but on the whole, U.S. farmers can switch easily among many agricultural markets.



MARKETS & PRICES *Many sellers use famous celebrities to differentiate their products.* ***What is the main goal of product differentiation?***

Monopolistic Competition

Monopolistic competition differs from perfect competition in one key respect—sellers offer different, rather than identical, products. Each firm seeks to have monopoly-like power by selling a unique product. Product variation is much more common than having identical products. As a result, monopolistic competition is much more common than perfect competition.

There are, however, similarities between the two systems. First, both buyers and sellers in monopolistic competition compete under the laws of supply and demand, just as they do in perfect competition. In addition, both systems feature many buyers and sellers acting independently, buyers who are well informed about products, and ease of market entry or exit.

Product Differentiation Sellers in monopolistic competition try to **differentiate**, or point out differences, between their products and those of their competitors. By pointing out differences—which can be real or merely seem real to consumers—sellers use **product differentiation** to set their products apart.

Nonprice Competition Sellers differentiate their products through **nonprice competition**. That is, they compete on a basis other than price. Consider the jeans market, for example. Designer jeans that cost $75 and "no-name" jeans that cost $25 are basically the same product. If consumers decided which jeans to buy based solely on price, no one would buy the more expensive designer jeans. In this market, however, manufacturers have succeeded in competing on a nonprice basis. They compete through advertising and by emphasizing their brand names.

In fact, many manufacturers spend millions of dollars on advertising to persuade buyers to purchase a particular brand of jeans based on style or the brand name instead of price. Many consumers are persuaded by such advertising. They are willing to buy the more expensive jeans because they believe that the designer's brand name makes the jeans more stylish and thus more valuable.

Profits The main goal of product differentiation and nonprice competition is to increase profits. By setting its product apart from the competition and convincing buyers to base their decision on nonprice factors, a seller can raise the price of its product above the competitive level and make more profit. The seller does this by increasing demand for its product, thereby shifting the market price upward.

You can see this type of shift in demand and equilibrium price in Figure 6.2. The demand

Careers in Economics

Advertising Account Manager

Who creates the attention-getting advertisements that you see on television or in your favorite magazine? One person responsible for bringing those advertisements from the drawing board to the television screen or magazine page is the advertising account manager.

Most ads are the result of a team effort by researchers, designers, and the account manager. While researchers analyze consumer needs and wants, designers develop an ad campaign that presents the product to the public. The account manager is the team captain, overseeing the campaign's development and ensuring that the client is happy with the ads.

Suppose that you are the account manager for Clinique cosmetics. You must determine what distinguishes Clinique products from other companies' cosmetics. Does the company offer makeup in a wider range of colors? Does a famous model or actress use Clinique products? As the account manager, you must persuade consumers to buy cosmetics from Clinique rather than from other companies such as Prescriptives and Max Factor.

Typically, account managers have college degrees in advertising. In addition to knowing how to produce an ad, communicate with the ad team and the client, and understand the market, an account manager must maintain a careful budget. By managing the team, market approach, and budget, an advertising account manager can create a winning campaign that ensures a successful product.

Advertising account managers organize the work of researchers and designers to meet the needs of the client.

Shift in Demand and Equilibrium Price

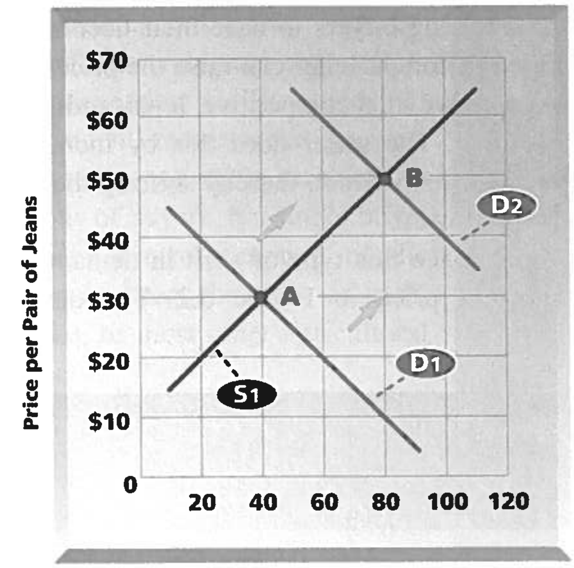


FIGURE 6.2 A demand curve shift results in a new equilibrium price. **What does point B indicate about supply and demand?**

curve D_1 represents the initial demand for Jean Luc brand jeans. The equilibrium price is $30 (point A). After the company launches a successful national advertising campaign, demand for Jean Luc jeans soars. The demand curve shifts to the right (D_2) as consumers are willing and able to buy more jeans at each and every price.

The equilibrium price of Jean Luc jeans shifts upward to $50, from point A on the old demand curve (D_1) to point B on the new demand curve (D_2). Thus, although the product did not change and basically is the same as other jeans on the market, the equilibrium price is different for this brand of jeans.

Generally, by differentiating its product and creating brand-name loyalty, a seller can gain some monopolylike control over price. The seller can use nonprice competition to carve a niche, or small share, for itself in the market—a niche it can monopolize, or dominate, and from which it can profit.

Sellers realize, however, that they are still subject to the law of demand. If the maker of Jean Luc jeans increases its price too much, there will be a surplus of Jean Luc jeans. Many buyers will return to making their decisions based on price and switch to a lower-priced competitor's jeans.

SECTION 1 REVIEW

1. Identify and Explain:
perfect competition
buyers
sellers
monopoly
monopolistic competition
differentiate
product differentiation
nonprice competition

2. Analyzing Information: Copy the diagram below. Use it to identify the four conditions that must exist for a market to be perfectly competitive.

3. Finding the Main Idea

a. How do buyers choose between products in perfect competition?

b. How does monopolistic competition differ from perfect competition?

c. Give an example of monopolistic competition.

d. How do sellers in monopolistic competition compete with one another?

4. Writing and Critical Thinking

Summarizing: Identify which conditions of perfect competition agricultural markets meet. Now identify at least one other perfectly competitive market. Explain your answer.

Consider:
- the characteristics of perfect competition
- similarities and differences in the agricultural and fishing industries

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