Chapter 52: Contestability 2016-Nov-1

- *Contestable market theory* vs. *neo-classical theory*
  - *Neo-classical theory* of oligopoly assumes presence of *high barriers to entry*
  - *Theory of contestable markets* allows presence of *low barriers to entry*
- *Assumptions* in the theory of contestable markets
  - *number of firms*: may vary from one (monopolist) to many
  - *freedom of entry to and exit from* market
  - firms *compete* with each other (no collusion to fix prices)
  - firms are *short run profit maximisers*: they produce where $MC = MR$
  - firms may produce *homogeneous goods* or *branded goods*
  - *perfect knowledge* in the industry
- Normal and abnormal profit
  - In a contestable market:
    - *abnormal profits* can be earned in the *short run*
    - only *normal profits* can be earned in the *long run*
  - Assume that firms were making *abnormal profit* in the short run
    - $\Rightarrow$ new firms would be attracted into industry (by abnormal profits)
    - $\Rightarrow$ supply increases & prices go down (until *only* normal profit is being made)
    - same mechanism as in the theory of *perfect competition*
- Entry to and exit from the industry
  - neo-classical theory:
    - large number of firms in industry $\Rightarrow$ *low barriers to entry* (e.g., perfect competition and monopolistic competition)
    - few firms in industry $\Rightarrow$ *high barriers to entry* (e.g., oligopoly and monopoly)
  - Assume that the *natural monopolist* is charging high prices and earning abnormal profit
    - $\Rightarrow$ *competitor* enters industry and takes market share by charging lower prices
    - $\Rightarrow$ the natural monopolist reacts by cutting prices

    * $\Rightarrow$ competitor leaves industry (unable to compete with these lower prices)
    * as long as *costs of leaving* (e.g., sunk costs) are low, it made sense for competitor to enter industry and earn profit at short run
  - In reality, *barriers to entry* are established by existing firms (e.g., soap industry invests a lot in branding)

- Potential competition
  - Previously, we discussed possibility for *existing firms* to earn *abnormal profit*
  - However, *contestable market theory* suggests that established furms in a contestable market earn only *normal profit* even in the short run
  - Assume that a monopolist is the established firm in an industry and it charges prices that would allow to make *abnormal profit*
    * $\Rightarrow$ another firm will enter the industry charging lower prices
    * the *new entrant* will remain as long as *existing firm* is earning *abnormal profit*
    * $\Rightarrow$ the existing firm will lower prices in order to *force out the new entrant*
    * $\Rightarrow$ once the new entrant is out, the established firm will put up prices again
    * $\Rightarrow$ as the established firm is making *abnormal profit* again, another new entrant will come and the same process will start over again ....
    * this is known as *hit and run competition* and the only way to avoid it would be for the existing firm to price at a level where there is only *normal profit*
  - Ability to earn *abnormal profit* depends on the barriers to entry and exit to industry (not on the number of firms in industry as in *neo-classical theory*)
  - with *low barriers*, existing firms will price such that $AR = AC$ (no abnormal profits are earned)

- Degrees of contestability
  - no market is perfectly contestable
  - there are always some barriers to entry and exit (has a deterrent effect on *hit and run competitors*)

- Review questions (pick the right answer and explain in detail!):

– General Motors made a loss of $4.3billion in 2009. Under which one of the following conditions are firms such as this likely to keep operating?
  - ☐ The market is highly contestable
  - ☐ They are covering average variable costs in the short run
  - ☐ Total revenue is less than total cost in the long run
  - ☐ They are covering marginal costs in the short run
  - ☐ There are low sunk costs in the industry

– Intel is the world's largest microchip manufacturer, supplying over 75% of the market. In May 2009 it was fined $1.44bn by the European Commission. It claimed that Intel gave secret payments to computer makers to use only Intel chips and paid a major retailer to stock only computers with its microchips. The most likely justification for this fine is that:
  - ☐ it ensured Intel would make a loss
  - ☐ the market for microchips is contestable
  - ☐ it would increase Intel's producer surplus
  - ☐ Intel was abusing its market power
  - ☐ the market for microchips has a low concentration ratio.

– ArcelorMittal is the world's biggest steelmaker. It uses a large quantity of coal in its production process. In October 2011 it made a bid to acquire Macarthur Coal in Australia. The proposed takeover bid was likely to have been motivated by a desire to achieve the benefits of
  - ☐ horizontal integration
  - ☐ increased contestability
  - ☐ decreased concentration
  - ☐ backwards vertical integration
  - ☐ forwards vertical integration