Revision of selected topics

Chapter 6, 7, 8, sample question, and the *Boston Matrix* –

January, 2017

MARKETS

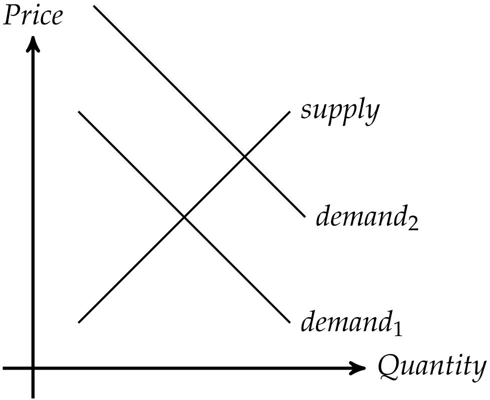
INTERACTION OF SUPPLY AND DEMAND

- *equilibrium price* or *market clearing price*: price where demand (wishes of consumers) equals supply (wishes of producers)
- *market is cleared* means that there are no buyers left without goods and no sellers with unsold stock
- Figure 1 (p.31):
  - shows (increasing) supply and (decreasing) demand
  - x-axis = quantity (Q) of goods (demanded and supplied)
  - y-axis = price (P) of goods
- *total revenue*: $TR = P \times Q$

MARKETS

CHANGES IN DEMAND

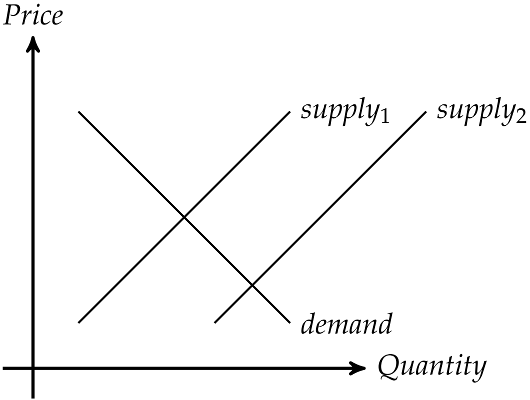
- if demand increase, price will increase
- graphically:
  - *increase* in demand = *shift* in the demand curve to the *right*



MARKETS

CHANGES IN SUPPLY

- if supply increase, price will fall
- graphically:
  - *increase* in supply = *shift* in the supply curve to the *right*



Markets

Changes in supply and demand together

- if both supply and demand increases, the effect on the price and quantity will depend on
  - *steepness* of the curves
  - *amplitude* of the change

Markets

Disequilibrium in the market

- if price is not at its *equilibrium level*
- *excess demand*: price charged in the market is *below* the equilibrium price
- *excess supply*: price charged in the market is *above* the equilibrium price

Price elasticity of demand

Definition

- *price elasticity demand*: relationship that exists between the responsiveness of demand and a change in price

$$\text{Price elasticity of demand} = \frac{\%\text{change in quantity demanded}}{\%\text{change in price}}$$

- *numerical values for the price elasticity*
  - price *inelastic*: when price elasticity < 1
  - price *elastic*: when price elasticity > 1

Income elasticity of demand

Definition

- *income elasticity demand*: responsiveness of demand to a change in *income*

$$\text{Income elasticity of demand} = \frac{\%\text{change in quantity demanded}}{\%\text{change in income}}$$

- *numerical values for the income elasticity*
  - income *inelastic*: when income elasticity < 1
  - income *elastic*: when income elasticity > 1
- *normal* vs. *inferior* goods:
  - normal goods: value of income elasticity is *positive*
  - inferior goods: value of income elasticity is *negative*

Sample paper

Question 3 (20 marks)

- Evaluate the likely impact on the finances of a business of using a pricing strategy such as that used by Ryanair.
  - see Exemplar (link on course webpage) page 22-25 for examples
- The 20 mark questions in Section C will require students to make links across the full course (Theme 1 and Theme 2) and students must focus on the concepts being asked for in the question.

Sample paper

Question 3 (20 marks)

The following answer is taken from the *exemplar*:

- *Structure* of your answer:
  1. *Definition*: A pricing strategy is a set of rules and ideas to be followed in order to place a price on a product by a firm.
  2. *Apply it to the context*: Ryanair's pricing strategy allows them to advertise in low initial price for flights and gain the attention of many consumers. They then capitalize and make profits with larger profit margins on complementary goods, such as food or baggage services where Ryanair is the only provider.

SAMPLE PAPER

QUESTION 3 (20 MARKS)

- *Structure* of your answer:
  3. *Analysis*: If a firm were to use a pricing strategy such as Ryanair, they would likely see an initial spike in demand as many customers would be drawn to the low advertising price. However, in order to advertise such a low price, it is unlikely to be a profitable venture and as such, profits from the advertised sale would likely fall or be negative. However, with the correct complement of necessary complementary goods with hogh profit margins, the losses could be recuperated and large profits could be generated. The increase in sales would give the firm a larger market share than previously in the short term.

Question 3 (20 marks)

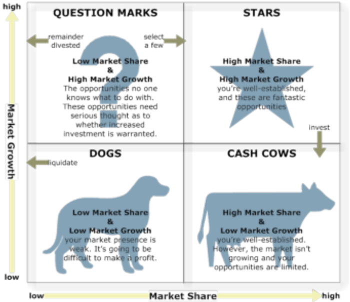
- *Structure* of your answer:
  4. *Downside*: However, consumers would soon realize that they have been baited into a deal where the overall cost may be greater than that of competitors. This immoral behaviour by the firm could generate poor publicity of the deal leading to many new consumers choosing to leave, as well as some existing consumers. This could lead to a long term tarnishing of the firm's reputation and a long term fall in sales. This can be seen with Ryanair, as they are often subject to jokes by many popular comedians such as Russel Howard.

- *Structure* of your answer:
    5. *Conclusion*: Overall, the extent to which a firm could benefit from this pricing strategy depends on the current economic climate and the price elasticity of demand of good/service. In a recession, consumers will be drawn more to lower price. This is also true if the demand is price elastic and there will be a mass surge in demand when price falls as dictated by the pricing strategy.

- *Examiner's comment*: This initially appears to be a strong response, with clear knowledge of pricing strategies, coherent chains of reasoning and contextual awareness in the early part of the response. However, beyond the second paragraph *the student has not focused sufficiently on the impact on the finances of the business* for a high Level 4 response. The response does not show full awareness of the validity and significance of competing arguments and does not lead to "balanced comparisons, judgements and an effective conclusion that proposes a solution and/or recommendations".
  This response therefore gained Level 3 and **14 marks out of 20**.

Boston Matrix

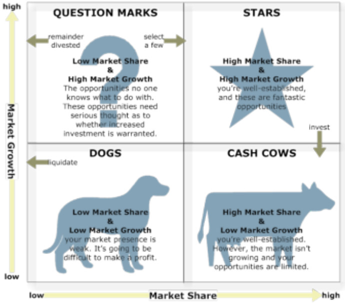
- It is difficult in practice to tell what *stage of the life cycle* a product is at
- Two criteria are used to *categorize products*
    1. *market growth*
    2. relative *market share*



Boston Matrix

Stars

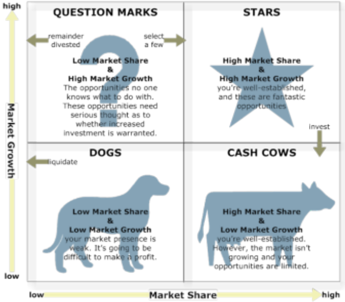
- product with *high market growth* and a relatively *high market share* $\rightarrow$ strong position in market
- product is likely to be *profitable* (high market share)
- business still needs to invest in the product (growing market $\rightarrow$ growing sales)
- *net cash flows* may be near zero: revenues $<$ investment spending



Boston Matrix

Cash cows

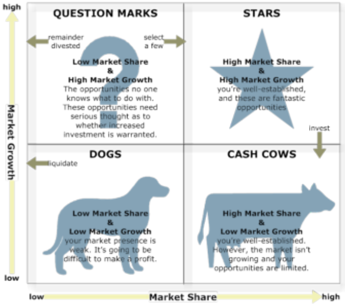
- product with a relatively *high market share* $\rightarrow$ well-positioned in market
- product is likely to be *profitable* (high market share)
- little chance of increasing sales & profits (weak growth in market)
- strong positive *net cash flows*: revenues $>>$ investment



Boston Matrix

Question marks

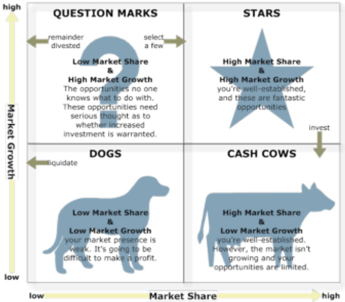
- product with *fast-growing market* and a relatively *low market share* → unclear what should be done with product
- product is unlikely to be *profitable* (low market share/ bad performance)
- potential to turn it into a *star* (fast-growing market)
- zero or negative *net cash flows*: revenues < investment



Boston Matrix

Dogs

- product with *low growth market* and a relatively *low market share*→ poor prospects for future sales & profits
- may generate positive *net cash flows*: revenues > investment (not much investment required)



Boston Matrix

Summary