CAPACITARTE

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Curso de inglés económico, de finanzas y tributos
Module 3. Economic Topics III

1. Market Competition – Perfect Competition

Economists classify markets based on how competitive they are.

Perfect competition is the ideal model of a market economy. It is useful as a model, but real markets are never perfect. Economists assess how competitive a market is by determining where it falls short of perfect competition.

Perfect competition has five characteristics:

1. Numerous buyers and sellers. No one seller or buyer has control over price.

2. Standardized product. Sellers offer a **standardized product**—a product that consumers consider identical in all essential features to other products in the same market.

3. Freedom to enter and exit markets. Buyers and sellers are free to enter and exit the market. No government regulations or other restrictions prevent a business or customer from participating in the market. Nor is a business or customer required to participate in the market.

4. Independent buyers and sellers. Buyers cannot join other buyers and sellers cannot join other sellers to influence prices.

5. Well-informed buyers and sellers. Both buyers and sellers are well-informed about market conditions. Buyers can do comparison shopping, and sellers can learn what their competitors are charging

2. Imperfect Competition

a) Monopoly

In the real world, there are no perfectly competitive markets because real markets do not have all of the characteristics of perfect competition.

Market structures that lack one of the conditions needed for perfect competition are examples of **imperfect competition**.

Perfect competition is the most competitive market structure. The least competitive is **monopoly**, a market structure in which only one seller sells a product for which there are no close substitutes. The term *monopoly* may be used for either the market structure or the monopolistic business.

Pure monopolies are as rare as perfect competition, but some businesses come close. For example, a **cartel** is a formal organization of sellers or producers that agree to act together to set prices and limit output. In this way, a cartel may function as a monopoly. Because a monopoly is the only seller of a product with no close substitutes, it becomes a **price maker**, a business that does not have to consider competitors when setting its prices. Consumers either accept the seller's price or choose not to buy the product. Other firms may want to enter the market, but they often face a **barrier to entry**—something that hinders a business from entering a market. Large size, government regulations, or special resources or technology are all barriers to entry.

The monopoly has some characteristics:

1 Only One Seller In a monopoly, a single business is identified with the industry because it controls the supply of a product that has no close substitutes.

2 A Restricted, Regulated Market In some cases, government regulations allow a single firm to control a market, such as a local electric utility.

3 Control of Prices Monopolists can control prices because there are no close substitutes for their product and they have no competition.

There are several reasons why monopolies exist, and not all monopolies are harmful to consumers. A **natural monopoly** is a market situation in which the costs of production are lowest when only one firm provides output. A **government monopoly** is a monopoly that exists because the government either owns and runs the business or authorizes only one producer. A **technological monopoly** is a monopoly that exists because the firm controls a manufacturing method, an invention, or a type of

technology. A **geographic monopoly** is a monopoly that exists because there are no other producers or sellers within a certain region.

Monopolistic competition has four major characteristics: many buyers for many sellers, similar but differentiated products, limited lasting control over prices, and freedom to enter or exit the market. Let's take a closer look at each of these characteristics by focusing on the market for hamburgers.

1 Many Sellers and Many Buyers In monopolistic competition there are many sellers and many buyers. The number of sellers is usually smaller than in a perfectly competitive market but sufficient to allow meaningful competition. Sellers act independently in choosing what kind of product to produce, how much to produce, and what price to charge. When you want a hamburger, you have many different restaurants from which to choose. The number of restaurants assures that you have a variety of kinds of hamburgers to choose from and that prices will be competitive.
No single seller has a large enough share of the market to significantly control supply or price. However, there are probably a few restaurants that make burgers you really like and others with burgers you really don't like. The restaurants that make your favorite burgers have a sort of monopoly on your business.

2 Similar but Differentiated Products Sellers in monopolistic competition gain their limited monopoly-like power by making a distinctive product or by convincing consumers that their product is different from the competition. Hamburger restaurants might advertise the quality of their ingredients or the way they cook the burger. They might also use distinctive packaging or some special service—a money-back guarantee if the customer is not satisfied with the meal, for example. One key method of product differentiation is the use of brand names, which encourage consumer loyalty by associating certain desirable qualities with a particular brand of hamburger. Producers use advertising to inform consumers about product differences and to persuade them to choose their offering. They conduct market research, the gathering and evaluation of information about consumer preferences for goods and services. For local restaurants, market research may be limited to listening to their customers' praise or complaints and paying attention to what competing restaurants offer. The large chain restaurants can afford to use more sophisticated research techniques to gain information about consumers' lifestyles and product preferences. One technique is the **focus group**—a moderated discussion with small groups of consumers. Another market research

technique is the survey, in which a large number of consumers are polled, one by one, on their opinions. The results of market research help the restaurants differentiate their hamburgers and attract more customers.

3 Limited Control of Prices Product differentiation gives producers limited control of price. Hamburger restaurants charge different prices for their product depending on how they want to appeal to customers. The price of some hamburgers is set as low as possible to appeal to parents of younger eaters or to those on tight budgets. Prices for name-brand hamburgers or burgers with better quality ingredients may be set slightly higher. If consumers perceive that the differences are important enough, they will pay the extra price to get the hamburger they want. Yet producers in monopolistic competition also know that there are many close substitutes for their product. They understand the factors that affect demand and recognize that consumers will switch to a substitute if the price goes too high.

4 Freedom to Enter or Exit Market There are generally no huge barriers to entry in monopolistically competitive markets. It does not require a large amount of capital for someone to open a hamburger stand, for example. When firms earn a profit in the hamburger market, other firms will enter and increase competition. Increased competition forces firms to continue to find ways to differentiate their products. The competition can be especially intense for small businesses facing much larger competitors. Some firms will not be able to compete and will start to take losses. This is the signal that it is time for those firms to exit the market. Leaving the restaurant market is relatively easy. The owners sell off the cooking equipment, tables, and other supplies at a discount. If their finances are solid, they may then look for another market where profits might be made.

Most markets in the real world fall somewhere between the models of perfect competition and monopoly. One of the most common market structures is **monopolistic competition,** in which many sellers offer similar, but not standardized, products. The market for T-shirts printed with images or slogans is one example. The market is competitive because there are many buyers (you, your friends, and many other buyers) and many sellers (stores at the mall, online merchants, sports teams, and many other sellers). The market is monopolistic because each seller has influence over a small segment of the market with products that are not exactly like those of their competitors.

Product differentiation and nonprice competition are the distinguishing features of monopolistic competition.

Product differentiation is the attempt to distinguish a product from similar products. Sometimes, the effort focuses on substantial differences between products, such as vehicle gas mileage ratings. But companies also try to differentiate their products when there are few real differences between products. For example, a battery company might spend millions of dollars on advertising to convince consumers that their batteries last longer than other batteries—even though the real difference in longevity may be minimal. Another way companies in monopolistic competitive markets try to gain business is through nonprice competition.

Nonprice competition means using factors other than low price—such as style, service, advertising, or giveaways—to try to convince customers to buy one product rather than another. If you've ever decided to eat at a particular fast food restaurant just to get the cool gizmo it's giving away, you have participated in nonprice competition.

b) Oligopoly

Oligopoly (OL-ih-GOP-ah-lee), a market structure in which only a few sellers offer a similar product, is less competitive than monopolistic competition. In an oligopoly, a few large firms have a large **market share**—percent of total sales in a market—and dominate the market. For example, if you want to see a movie in a theater, chances are the movie will have been made by one of just a few major studios. What's more, the theater you go to is probably part of one of just a few major theater chains. Both the market for film production and the market for movie theaters are oligopolies. There are few firms in an oligopoly because of high **start-up costs**—the expenses that a new business must pay to enter a market and begin selling to consumers. Making a movie can be expensive, especially if you want to make one that can compete with what the major studios produce. And getting it into theaters across the country requires a huge network of promoters and distributors—and even more money.

An oligopoly has four major characteristics:

- **There are few sellers but many buyers.** In an oligopoly, a few firms dominate an entire market. There is not a single supplier as in a monopoly, but there are

fewer firms than in monopolistic competition. These few firms produce a large part of the total product in the market.

Economists consider an industry to be an oligopoly if the four largest firms control at least 40 percent of the market. The breakfast cereal industry in the United States is dominated by four large firms that control about 80 percent of the market. Although they offer many varieties of cereals, there is less competition than there would be if each variety were produced by a different, smaller manufacturer.

- In industrial markets, sellers offer standardized products, but in consumer markets, they offer differentiated products. Depending on the market, an oligopolist may **sell either standardized or differentiated products.** Many industrial products are standardized, and a few large firms control these markets. Examples include the markets for steel, aluminum, and flat glass. When products are standardized, firms may try to differentiate themselves based on brand name, service, or location. Breakfast cereals, soft drinks, and many other consumer goods are examples of differentiated products sold by oligopolies.

  Oligopolists market differentiated products using marketing strategies similar to those used in monopolistic competition. They use surveys, focus groups, and other market research techniques to find out what you like. The companies then create brand-name products that can be marketed across the country or around the world.

- The few sellers have more power to control prices than in monopolistic competition. Because there are few sellers in an oligopoly, each one has **more control over product price** than in a monopolistically competitive market. For example, each breakfast cereal manufacturer has a large enough share of the market that decisions it makes about supply and price affect the market as a whole. Because of this, a seller in an oligopoly is not as independent as a seller in monopolistic competition. A decision made by one seller may cause the other sellers to respond in some way. For example, if one of the leading breakfast cereal manufacturers lowers its prices, the other manufacturers will probably also lower prices rather than lose customers to the competition. Therefore, no firm is likely to gain market share based on price, and all risk losing profits. But if one manufacturer decides to raise prices, the others may not follow suit, in order to take customers and gain market share. Consequently, firms in an oligopoly try to anticipate how their competitors will respond to their actions before they make decisions on price, output, or marketing.

- **To enter or exit the market is difficult**. Start-up costs for a new company in an oligopolistic market can be extremely high. Entering the breakfast cereal industry on a small scale is not very expensive—but the profits are low too. The factories, warehouses, and other infrastructure needed to compete against the major manufacturers require large amounts of funds. In addition, existing manufacturers may hold patents that act as further barriers to entry. Firms in an oligopoly have established brands and plentiful resources that make it difficult for new firms to enter the market successfully. For example, breakfast cereal manufacturers have agreements with grocery stores that guarantee them the best shelf space. Existing manufacturers also have economies of scale that help them to keep their expenses low. Smaller firms, with smaller operations, lack the economies of scale. However, all of the investments by firms in an oligopoly make it difficult for them to exit the market. When a major breakfast cereal manufacturer begins losing money, its operations are too vast and complex to sell and reinvest easily, as a small business might. It must trim its operations and work to stimulate demand for its product.

C) Market Structures

Each of the four market structures has different benefits and problems. And each type creates a different balance of power—namely, the power to influence prices— between producers and consumers.

Consumers get the most value in markets that approach perfect competition. No actual markets are perfectly competitive, but in those that come close, prices are set primarily by supply and demand. However, such markets usually deal in a standardized product, so consumers have little choice other than the best price.

In monopolistic competition, consumers continue to benefit from companies competing for their business. But businesses gain some control over prices, so they are more likely to earn a profit. Opening a business in such a market is usually relatively affordable, which is another benefit for businesses.

In markets dominated by oligopolies, consumer choices may be more limited than in more competitive markets. Businesses in such markets gain more control of price, making it easier for them to make a profit. However, the cost of doing business in such a market is high.

A market ruled by a monopoly is very favorable for the business that holds the monopoly. It faces little or no competition from other companies. And monopoly gives consumers the least influence over prices. They decide only whether they are willing to buy the product at the price set by the monopolist.

3. International Trade

A nation's economic patterns are based on its unique combination of factors of production: natural resources, human capital, physical capital, and entrepreneurship. Because each nation has certain resources and cannot produce everything it wants, individuals and businesses must decide what goods and services to focus on. The result is **specialization**, a situation that occurs when individuals or businesses produce a narrow range of products. Through specialization, businesses can increase productivity and profit—the driving force of world trade. Specialization also leads to **economic interdependence**, a situation in which producers in one nation depend on others to provide goods and services they do not produce.

Most economies believe in free trade, in which people and companies should be able to buy goods from all countries, without any barriers when they cross frontiers. The comparative cost principle is that countries should produce whatever they can make the most cheaply. Countries will raise their living standards and income if they specialize in the production of goods and services in which they have the highest relative productivity. Countries can have absolute advantage, so that they are the cheapest in the world, or a comparative advantage so that they are only more efficient than some other countries in producing certain goods or services. This can be because they have raw materials, a particular climate, qualified labour (skilled workers), and economies of scale (reduced production costs because of large-scale production).

A. Balance of Payment

Because of the law of comparative advantage, nations gain through trading goods and services. Goods and services produced in one country and sold to other countries are called **exports**. Goods and services produced in one country and purchased by another are called **imports**. The costs and benefits of international trade vary by nation. To understand how trade affects a nation's economy, economists use supply and demand analysis. They look at the impact of exports and imports on prices and quantity.

A country that exports more goods than it imports has a positive balance of trade or a trade surplus. The opposite is a negative balance of trade or a trade deficit. Trade in goods is sometimes called visible trade. Services such as banking, insurance and tourism are sometimes called invisible imports and exports. Adding invisibles to the balance of trade gives a country's balance of payments.

B. Trade Barriers

In order to offer some short-term protection to jobs and industries located within their borders, almost all nations pass some sort of laws that limit trade. These laws lead to higher prices on the restricted items or to economic retaliation by other nations. In the end, these industries and the jobs they provide can only be saved by becoming more competitive. The issue of trade restrictions is basically political in nature, and governments struggle to find the best policies to enact.

A **trade barrier** is any law passed to limit free trade among nations. There are five basic types of trade barriers. Most are mandatory, but some are voluntary.

The first trade barrier is **Quotas.** Nations often impose **quotas**, limits on the amount of a product that can be imported. For example, the United States had quotas on the amount of textiles allowed to be imported. These quotas limited supply and kept textile prices relatively high, but increased in other nations. This practice of **dumping**, the sale of a product in another country at a price lower than that charged in the home market, hurts domestic producers but provides consumers a lower price.

Secondly, there are **Tariffs**, a fee charged for goods brought into a country from another country. There are two types of tariffs: revenue and protective. **Revenue tariffs**, taxes on imports specifically to raise money, are rarely used today. In the past, however, nations regularly used them as a source of income. Today nations use **protective tariffs**, taxes on imported goods, to protect domestic goods. Protective tariffs raise prices on goods produced more cheaply elsewhere, thereby minimizing the price advantage the imports have over domestic goods.

Another trade barrier is the **Voluntary Export Restraint.** To avoid a quota or a tariff, a country may choose to limit an export. It usually comes about when a trade ambassador from one nation makes appeals to a counterpart, warning of possible consequences without the VER.

Embargoes is a type of trade barrier. An **embargo** is a law that cuts off most or all trade with a specific country. It is often used for political purposes. Since the early 1960s, for example, the United States has had an embargo on trade with Communist Cuba. Other trade restrictions are indirect. Licenses, environmental regulations, and health and safety measures (such as a ban on the use of certain herbicides) are, in effect, trade barriers.

Considering all the disadvantages of trade barriers, why would a country enact such laws? The answer lies in the concept of **protectionism**, the use of trade barriers between nations to protect domestic industries. Protectionists argue that trade barriers protect domestic jobs and promote **infant industries** (new industries that are often unable to compete against larger, more established competitors). These actions generally protect inefficient production and result in higher prices for everyone. Voters in industrial areas bring their voices to the national debate about foreign trade. By doing so, they have helped bring about federal job training programs for workers who find themselves unemployed as a result of the movement of jobs to places where the per unit cost of labor is lower. The idea behind protecting infant industries is to assist newly developing industries in their growth process until they are able to compete with better-developed foreign rivals. Critics say that, provided with a sheltered existence that is free from the need to compete on equal terms, these industries settle into perpetual infancy. And a perpetual infant needs perpetual support.

C. Exchange Rates

An exchange rate is the price at which one currency can be exchanged for another (e.g. how many yen are need to buy a euro).

In theory, exchange rates should be at the level that *Purchasing Power Parity* (PPP), which means that the cost of a given selection of goods and services would be the same in different countries. So if the price level in a country increases because of inflation, its currency should depreciate (the exchange rate should go down to return to PPP).

Exchange rates can change due to currency speculation, buying currencies in the hope of making a profit. Financial institutions, companies and rich individuals all buy currencies looking for high interest rates or short-term capital gains when currencies increases in value or appreciates. They make considerable profits from the spread between a currency's buying and selling prices.

For 25 years after World War II, the levels of most major currencies were determined by governments. They were fixed or pegged against the US Dollar, and the dollar was pegged against gold. This system is known as gold convertibility.

Since the early 1970s, there has been a system of floating exchange rates worldwide. These rates are determined by people buying and selling currencies in the foreign exchange markets. A freely floating exchange rate means one which is determined by market forces. The currency price will rise if there are more buyers, and it will fall if there are more sellers.

Government and central banks sometimes try to change the value of their currency. They intervene in exchange markets using foreign currency reserves to buy their own currency to raise its value, or selling to lower it. This is known as managed floating exchange rate.

D. Financing International Trade

Importers and exporters use different ways to financing international trade. They have different methods of payments:

- **Documentary Credit (Letter of credit)**

It is a written promise by a bank to pay a certain amount to the seller, within a fixed period, when the bank receives instructions from the buyer.

They are usually **irrevocable** (they guarantee that the bank which establishes the letter of credit will pay the seller of the documents presented within the agreed time).

They generally contain:

- A short description of the goods
- A list of shipping documents required to obtain payment
- A final shipping date
- A final date (expiration date) for presenting the documents to the bank.

- **Bill of exchange or Draft**

It is a payment demand written or drawn up by an exporter, instructing an importer to pay a specific sum of money on a future day.

- **Export Documents**

Exporters have to prepare a number of documents to go with the shipment or transportation of goods.

- **Commercial invoice** containing details of goods and information about the transportation.
- **Bill of lading**, a document signed by the carrier or transporter confirming the goods have been received for shipment. It contains a brief description of the goods and the details of destination.
- **Insurance certificate**, which describes the goods carried and contains details of how to claim if they are lost or damaged in transit (transported)
- **Certificate of origin**, which states where the goods come from.
- **Quality and weight certificates** issued by private inspection and testing company to confirm the goods are the correct ones in the right quantity.
- **Export licenses** giving the right to sell particular goods abroad is required.

INCOTERMS

They are standard arrangements, expressed in short for International Commercial Terms, and established by the International Chamber of Commerce.

They determine who will pay additional costs (whether the buyer or the seller).

Additional costs include:

- ✓ Transportation or shipment
- ✓ Documentation (preparing all the necessary documents)
- ✓ Customs Clearance (completing import documents and paying any import duties or taxes)

- ✓ Transport Insurance