Introduction to Economics I
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Oligopoly

An **oligopoly** is a market form wherein a market or industry is dominated by a small number of large sellers (oligopolists).

Oligopolies can result from various forms of collusion which reduce competition and lead to higher prices for consumers.

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Concentration ratios

Oligopolies may be identified using concentration ratios, which measure the proportion of total market share controlled by a given number of firms. When there is a high concentration ratio in an industry, economists tend to identify the industry as an oligopoly.

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Example of a hypothetical concentration ratio

The following are the annual sales, in £m, of the six firms in a hypothetical market:

A = 56

B = 43

C = 22

D = 12

E = 3

F = 1

In this hypothetical case, the 3-firm concentration ratio is 88.3%, that is 121/137 x 100.

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The Herfindahl – Hirschman Index (HH index)

- This is an alternative method of measuring concentration and for tracking changes in the level of concentration following mergers.
- The HH index is found by adding together the squared values of the % market shares of all the firms in the market.

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The Herfindahl – Hirschman Index (HH index)

- For example, if three firms exist in the market the formula is $X^2 + Y^2 + Z^2$; where X, Y and Z are the percentages of the three firm's market shares.
- If the index is below 1000, the market is not considered concentrated, while an index above 2000 indicates a highly concentrated market or industry – the higher the figure the greater the concentration.

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Barriers to entry

Oligopolies and monopolies frequently maintain their position of dominance in a market might because it is too costly or difficult for potential rivals to enter the market.

These hurdles are called *barriers to entry* and the incumbent can erect them deliberately, or they can exploit natural barriers that exist.

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Pricing strategies of oligopolies

Oligopolies may pursue the following pricing strategies:

1. Oligopolists may use predatory pricing to force rivals out of the market. This means keeping price artificially low, and often below the full cost of production.
2. They may also operate a *limit-pricing* strategy to deter entrants, which is also called *entry forestalling price*.

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Pricing strategies of oligopolies

1. Oligopolists may *collude* with rivals and raise price together, but this may attract new entrants.
2. *Cost-plus pricing* is a straightforward pricing method, where a firm sets a price by calculating average production costs and then adding a fixed *mark-up* to achieve a desired profit level. Cost-plus pricing is also called *rule of thumb* pricing.

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Maximizing profits

MC = MR is profit maximizing rule.

However, P is set above the MC.

Hence, we can conclude that P>MR=MC.

Output in oligopoly is greater than the monopoly, but lower than the output produced in perfect competition.