

Scale Economies and Imperfect Competition

KOM, Ch 7, selected pages:

- What are economies of scale, and how do external economies of scale differ from internal economies of scale? <: **Economies of scale (also called increasing returns to scale) are present when increasing the inputs raises output more than in proportion; e.g., if doubling the inputs more than doubles the output. Internal economies of scale happen within a firm – if it gets larger its average cost goes down. External economies happen in the industry but not the firm. That is, the average cost of all firms in the industry goes down as the industry output rises.>**
- What are some reasons why the costs of a number of firms producing the same thing might be lower if they are located close together than far apart? <: **Specialized suppliers; labor market pooling; knowledge spillovers.>**
- The supply curve with external economies is shown and described in the text as “forward falling.” Can this be interpreted the same way as a conventional upward sloping supply curve, saying how much industry will supply at each given price? [Also, though not mentioned in the text, how does this differ from a “backward bending supply curve” that one sees in other contexts, such as labor supply?] <a: **Not really, since you’d think that suppliers facing a price would want to produce more to lower cost, but they can’t because the scale economies are external. Better to think of starting with output and looking at the market-clearing price on the demand curve, and then profits and the incentive to expand or contract. [Both forward-falling and backward-bending are downward sloping, but the latter really does have suppliers wanting to supply less at a higher price.]>**
- In what ways does the opening to trade of an industry with external economies of scale differ from what we saw in the partial equilibrium models earlier in the course?
 - Do low-cost suppliers still export? <: **Not necessarily, in the sense one would want. A large higher-cost suppliers may have lower initial cost than a small supplier, and thus capture the market.>**
 - Do high-cost suppliers still reduce production, and their countries import? <: **Yes, if their cost is high initially. In fact they shut down.>**
 - Does price rise in the low-price country and fall in the high-price country? <: **No, it falls in both.>**
 - Does a move to free trade cause winners and losers in both countries? <: **No. Suppliers lose in the importing country while demanders gain. But in the exporting country, since costs fall, both suppliers and demanders gain.>**

KOM, Ch 8, selected pages:

- What two things contribute to the gap between price on a demand curve facing a monopolistic firm and its marginal revenue? How then is this related to the markups of price above marginal cost that firms charge? **<a: The size of its output, on all of which it must lower price in order to sell an additional unit, and the slope of the demand curve, the steeper it is implying that it must lower price more in order to sell an additional unit. Since in equilibrium firms equate marginal revenue to marginal cost, these same features determine markups.>**
- Why do “internal economies of scale” lead to imperfect competition? **<a: Because any firm that manages to become larger than its competitors will have lower cost and therefore be able to push them out of the market, until the number of firms becomes small.>**
- The monopolistic competition model in the text is depicted with two curves, the upward sloping CC curve and the downward sloping PP curve, with the number of firms in the industry, n , on the horizontal axis. What, intuitively, do these two curves represent, and why are they shaped as they are? **<a: The CC curve simply shows the average cost of a representative firm, which rises with n because with more firms each will sell a smaller quantity and thus must divide their fixed costs across fewer units. The PP curve shows the profit maximizing prices charged by firms, as a markup over their fixed marginal costs. As they compete with more other firms the elasticity of demand that they face rises and they must lower their markups and their prices.>**
- What assumption is captured by saying that the equilibrium is the intersection of the CC and PP curves? **<a: Free entry and exit, so that firms enter if profit is positive, as it is if $P > AC$, and exit if profit is negative.>**
- Why can the monopolistic competition model lead to trade without comparative advantage? **<a: Because the model yields trade between countries, even if they are identical.>**
- The “New Trade Theory,” of which the monopolistic competition model is a part, departs from the assumptions of earlier trade theories (Ricardian, Heckscher-Ohlin) by dropping three assumptions: perfect competition, constant returns to scale, and product homogeneity. What are the replacements of each of these in the textbook’s monopolistic competition model, and how do each contribute a new reason for gain from trade? **<a: Perfect competition is replaced by monopolistic competition, in which trade increases competition and thus reduces the markups of price over marginal cost that cause deadweight losses in the economies. Constant returns to scale are replaced by increasing returns to scale that arise from fixed costs, and trade then allows a smaller number of firms each to produce more output and thus reduce average cost. And product homogeneity is replaced by differentiated products, the presence of which means the consumers can benefit from access to a wider variety of goods, and greater trade, while it reduces the number of varieties produced in each country, also increases the number of varieties (domestic and imported) available to consumers, making them better off.>**

- In the monopolistic competition model, are there any losers from trade? **<a: Yes. When countries open to trade, firms initially lower their prices due to the increased competition, and therefore make losses. Only after some firms exit are zero profits restored with a reduced number of firms. All must have lost during that adjustment, and the exiting firms only lose.>**