IJC 2014 H2 Prelim 2 Paper Question 2

As the growth of online shopping continue, shoppers are focused on purchasing electronics, books, music, apparel and sporting goods. On the other hand, food and beverages, supermarkets, luxury fashion and healthcare tend to be less affected by the shift towards online retail and continued to perform well.

(a) Explain how economies of scale determine the type of market structure in different industries. [10]

Suggested Outline:

- Define economies of scale, minimum efficient scale. Explain that the extent of economies of scale reaped by firms determine the size of firms and hence the type of market structure.

- Firm where MES is small relative to industry demand means that the optimal size of the firm is small and thus there are many small sized firms in the industry. These firms will experience lowest average costs at a low level of output only and are thus remain small in size. For example, fashion boutique and barber shop. Hence, such industries are likely to exist in monopolistic competition where there is a large number of small firms.

- Firm where MES is large relative to industry demand means there may be room for only one or a few large sized firms. These industries tend to have high capital cost and is more likely to exploit technical economies of scale. Examples of such industries include telecommunication, public utilities and aircraft production. In these industries, there is no possibility of competition from within the country. Even if a firm were large enough to produce the whole output of the industry in the country, it would still not be large enough to experience the full potential economies of scale. As a result, the LRAC curve falls continuously over the entire output range sufficient to supply the entire market. Such industries are likely to be oligopolistic, with a few large firms dominating the market. In the extreme case, with only one firm in the market it might exist as a monopoly.

- In some industries, the firms' LRAC curve may have a horizontal portion due to constant returns to scale. These firms can enjoy lowest average costs over a range of output. It is possible for small and large firms to be equally cost efficient and co-exist in the same industry. For example, in the retail industry, there exist small grocery stores and large supermarkets. Hence firms in these industries can be either oligopolistic (e.g. supermarket chains) or monopolistic competitive (e.g. grocery stores).

Marking Descriptor

Level	Descriptor	Marks
L3	Clear attempt to address question. Well-developed analysis of how economies of scale determine the size of firms, number of firms and market structure in different industries with the good use of relevant examples.	7-10
L2	Some attempt to address question. Less developed analysis of how economies of scale determine the size of firms, number of firms and market structure in different industries. Answer is generally descriptive or lacking in scope in terms of type market structures considered and examples.	5-6
L1	Answer mostly irrelevant or contains only a few valid points made incidentally without any attempt to address question.	1-4

(b) Discuss how far the market structure of the firms in different retail industries will affect their profitability when faced with the growth in online shopping. [15]

Suggested Outline:
With growth in online shopping, the retail industries are impacted in different ways

Growth in online shopping → greater competition for existing traditional firms due to more producers in the market
Extent to which existing traditional firms' profits are affected depends on market structure firms operate in

- Retail industries with monopolistic competitive features
  E.g. fashion boutiques
  Lack of excess profits due to freedom of entry and exit industry
  Growth in online shopping → fall in demand → some firms might be making subnormal profits eventually → exit the industry in the long run

- Retail industries with oligopolistic features
  E.g. supermarkets
  Able to maintain supernormal profits due to substantial barriers to entry which prevent firms from entering
  Growth in online shopping → falling demand → fall in revenue but might still be able to maintain supernormal profits if reduction in revenue is not drastic

In comparison, the impact might be more favourable for online retail industries
Growth in online shopping → rising demand as consumers switch to online retail firms which are substitutes of traditional retail firms
Extent to which it favours these industries might also depend on the market structure firms operate in

- Retail industries with oligopolistic features
  E.g. large internet firms
  Ability to maintain high barriers to entry → prevent new firms from entering → supernormal profits can be maintained in the long run
  Greater ability to use supernormal profits to innovate, differentiate, advertise → raise barriers in the industry → raising market power and profits further

- Retail industries with monopolistic competitive features
  E.g. blog shops
  Growth in online shopping rising demand → rising revenue → rise in profits → supernormal profits earned in the short run
  However, monopolistic competitive industries have freedom of entry and exit of firms → attract new firms into the industry → fall in demand and demand becoming more elastic with presence of more substitutes → supernormal profits competed away → normal profits earned in the long run

Market structure is not the only factor affecting firms' profitability. When faced with growth in online shopping, firms' profitability can be dependent on other factors:

(i) Ability of firms to adopt competitive strategies:
- Product Differentiation

When faced with growth in online shopping, if retailers are able to differentiate their products in terms of range, designs and quality, they may be able to make their products less substitutable and thus the demand for their products becomes more price inelastic. With that, such retailers may be able to earn higher profits

- Firms changing strategy by tapping on growth potential in online shopping, especially for those products experience favourable growth in sales online, such as some products like electronics, books, music, apparel and sporting goods

(ii) Nature of product

- Products that are highly specialised, requiring more personalised service less likely to be impacted by growth in online shopping

  E.g. in the market for food and beverage, apparels, consumers with greater affluence and purchasing power often places a high premium and value on variety, personalized services and choices such as unique dining experience or high-end luxury fashion serving a niche market
- Goods that are perishable and have more limited shelf life, e.g. those in supermarkets, profitability less impacted by the growth in online shopping

Conclusion:
Market structure of firms in retail industries can affect their profitability when faced with growth in online shopping to some extent, but other factors like competitive strategies that firms adopt and nature of product might prove to be important affecting their profitability as well

Marking Descriptor

Level	Descriptor	Marks
L3	Clear attempt to address question. A balanced discussion with well-developed analysis of how market structure and other relevant factors can affect retail firms' profitability when faced with growth in online shopping.	9-11
L2	Some attempt to address question. Less balanced and developed analysis of how market structure and other relevant factors can affect retail firms' profitability when faced with growth in online shopping.	6-8
L1	Answer mostly irrelevant or contains only a few valid points made incidentally without any attempt to address question.	1-5
E2	Evaluation that is supported by economic reasoning.	3-4
E1	Some evaluation but may not be supported by sound economic reasoning.	1-2