

**Subject: Microeconomic Theory I**

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### **Monopsony Power in Markets**

- A monopsony has **buying or bargaining power** in their market.
- This buying power means that a monopsony can exploit their **bargaining power** with a supplier to negotiate lower prices.
- The reduced cost of purchasing inputs increases their **profit margins** increasing the chances of a business making **super-normal profit**
- Monopsony exists in both product and labour markets – in this chapter we focus on buying power in the markets for goods and services

### **Examples of industries where monopsony power exists and persists:**

1. Electricity generators can negotiate lower prices for coal and gas supply contracts'
2. Food retailers have power when purchasing supplies from farmers, milk producers, wine growers and other suppliers. Tesco, Sainsbury, Wal-Mart-Asda and Cooperative-Somerfield have **oligopsony power** when it comes to purchasing products from businesses at earlier stages of the supply-chain.
3. A **car-rental firm** seeking a contract to a manufacturer to supply new cars for their fleet
4. **Low-cost airlines** getting a favourable price when purchasing a new fleet of aircraft
5. British Sugar buys almost the entire sugar beet crop produced in the UK year

6. Amazon's buying power in the retail book market – it gets a better price than other booksellers and this gives it a significant competitive advantage.
7. The increasing buying power of countries – for example China – in securing deals to buy mineral deposits from other countries – often in less developed nations in Africa.
8. The **government** is a major buyer e.g. in military procurement – and might be able to use this bargaining power when confirming contracts for new military equipment and supplies. The National Health Service is another example of a dominant buyer – in this case as a purchaser of prescription drugs from the pharmaceutical companies.

### Evaluating the economic welfare effects of monopsony power in markets

In evaluation it is important to remember some of the possible advantages from monopsony power:

1. **Improved value for money** – for example the UK national health service can use its bargaining power to drive down the prices of routine drugs used in NHS treatments and ultimately this means that cost savings allow for more treatments within the NHS budget.
2. **Producer surplus** has a value as well as consumer surplus – lower input costs will raise profitability that might be used to fund capital investment and research.
3. A monopsony can act as a useful counter-weight to the selling power of a monopolist e.g. the NHS versus the global pharmaceutical companies.
4. In most supply chain relationships – for example between supermarkets and their suppliers – the long term sustainability of an industry requires that both benefit – if there are no mutually beneficial **gains from trade**, ultimately trade and exchange will break down.
5. The growth of the **Fair Trade** label and organisation is evidence of how pressure from consumers can lead to improved contracts and prices for farmers in developing countries. For example if tea producers in Rwanda get a stronger price for their output, the increased income and profit will have important economic and social benefits for the exporting industry and the wider economy.
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## **Monopsony and Monopoly Compared**

Monopsony is easier to understand if you compare it with monopoly. Recall that a monopolist can charge a price above marginal cost because it faces a downward-sloping demand, or average revenue curve, so that marginal revenue is less than average revenue. Equating marginal cost with marginal revenue leads to a quantity  $Q^*$  that is less than what would be produced in a competitive market, and to a price  $P^*$  that is higher than the competitive price  $P_c$ . The monopsony situation is exactly analogous, the monopsonist can purchase a good at a price below its marginal value because it faces an upward-sloping supply, or average expenditure, curve. Thus, for a monopsonist, marginal expenditure is greater than average expenditure. Equating marginal value with marginal expenditure leads to a quantity  $Q^*$  that is less than what would be bought in a competitive market, and to a price  $P^*$  that is lower than the competitive price  $P_c$ .

## **Monopsony Power**

- Much more common than pure monopsony are markets with only a few firms competing among themselves as buyers, so that each firm has some monopsony power. For example, the major U.S. automobile manufacturers compete with one another as buyers of tires. Because each of them accounts for a large share of the tire market, each has some monopsony power in that market. General Motors, the largest, might be able to exert considerable monopsony power when contracting for supplies of tires (and other automotive parts). In a competitive market, price and marginal value are equal. A buyer with monopsony power, however, can purchase a good at a price below marginal value. The extent to which price is marked down below marginal value depends on the elasticity of supply facing the buyer. If supply is very elastic ( $ES$  is large), the markdown will be small and the buyer will have little monopsony power. Conversely, if supply is very inelastic, the markdown will be large and the buyer will have considerable monopsony power.

## **Sources of Monopsony Power**

What determines the degree of monopsony power in a market?

Again, we can draw analogies with monopoly and monopoly power. We saw that monopoly power depends on three things: the elasticity of market demand, the number of sellers in the market, and the way those sellers interact. Monopsony power depends on three similar things:

The elasticity of market supply,

The number of buyers in the market,

The way those buyers interact

**ELASTICITY OF MARKET SUPPLY** A monopsonist benefits because it faces an upward-sloping supply curve, so that marginal expenditure exceeds average expenditure. The less elastic the supply curve, the greater the difference between marginal expenditure and average expenditure and the more monopsony power the buyer enjoys. If only one buyer is in the market—a pure monopsonist—its monopsony power is completely determined by the elasticity of market supply. If supply is highly elastic, monopsony power is small and there is little gain in being the only buyer

### **NUMBER OF BUYERS**

Most markets have more than one buyer, and the number of buyers is an important determinant of monopsony power. When the number of buyers is very large, no single buyer can have much influence over price. Thus, each buyer faces an extremely elastic supply curve, so that the market is almost completely competitive. The potential for monopsony power arises when the number of buyers is limited.

### **INTERACTION AMONG BUYERS**

Finally, suppose three or four buyers are in the market. If those buyers compete aggressively, they will bid up the price close to their marginal value of the product, and will thus have little monopsony power. On the other hand, if those buyers compete less aggressively, or even collude, prices will not be bid up very much, and the buyers' degree of monopsony power might be nearly as high as if there were only one buyer. So, as with monopoly power, there is no simple way to predict how much monopsony power buyers will have in a market. We can

count the number of buyers, and we can often estimate the elasticity of supply, but that is not enough.

Monopsony power also depends on the interaction among buyers, which can be more difficult to ascertain.

## **Books**

1. Pindyck and Rubinfeld with Mehta (2005), Microeconomics- latest available Edition in market.
2. D.N Dwivedi (2016), Microeconomics Theory and Application-- latest available Edition in market.
3. Walter Nicholson, Microeconomic Theory, Tenth Edition, Thomas Learning New York
4. Koutsoyiannis, A., Modern Microeconomics, Macmillan, London.