Monopsony

Multiple-Choice and Essay Questions

GCE A-LEVEL ECONOMICS

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B is a monopoly supplier of labour.

C equates the marginal revenue product of labour with its marginal cost not the wage rate.

D restricts output to raise the price of the product sold.

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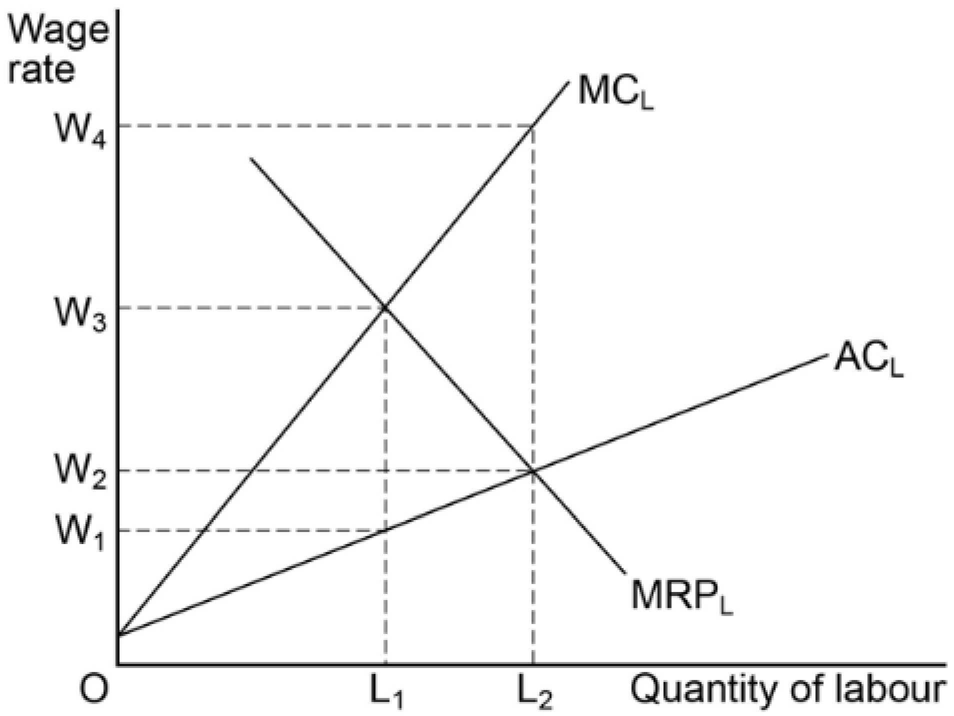
The diagram below shows the Marginal Revenue Product of Labour (MRP_L), Marginal Cost of Labour (MC_L) and Average Cost of Labour (AC_L) curves in a market where there is a single employer but labour is supplied competitively.



The employer's profit-maximising wage rate and level of employment is a

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B wage of W_2 and employment of L_2

C wage of W_3 and employment of L_1

D wage of W_4 and employment of L_2

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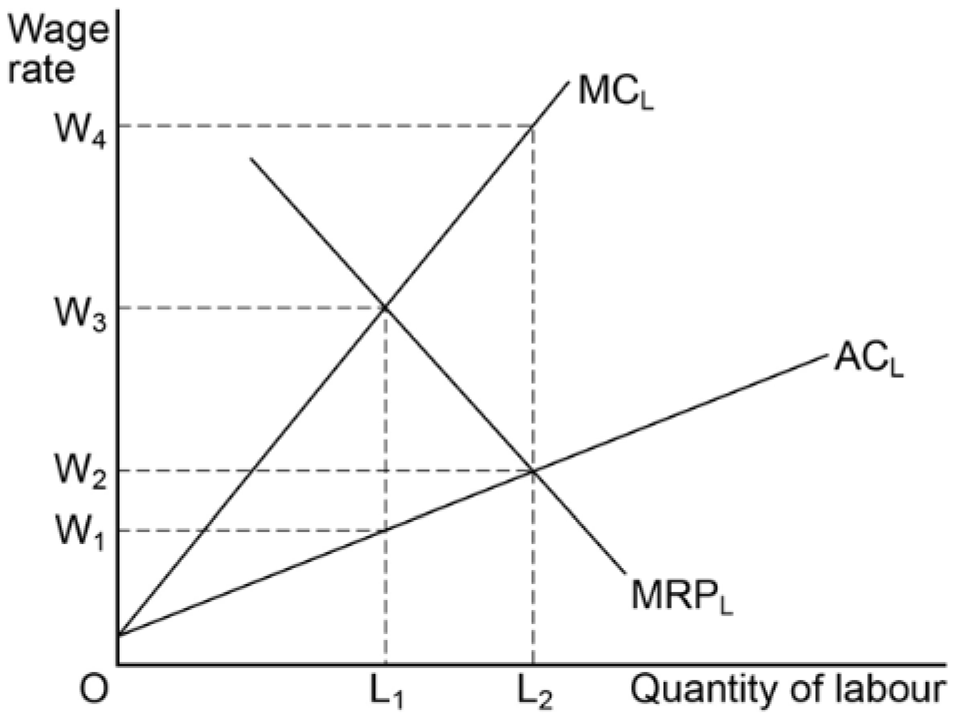

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Extract 1 Supermarket pricing makes merger of Chiquita and Fyffes necessary

Bananas have become the biggest fruit on the planet in terms of production volume, as consumers eat ever more of them. Global banana production has doubled since 1990 to 100 million tonnes a year. A deal to create the world's largest banana distributing company was arguably made necessary by the low fresh fruit prices to be found on the shelves of any supermarket. By planning a $1 billion merger, Chiquita of the US and Dublin-based Fyffes are attempting to address a retail price squeeze that is reducing their already low profit margins. Their profit margins have been shrinking: Chiquita's from 3.5% in 2004 to 0% in 2012, and Fyffes' from just under 5% to 3.5% over the same period, say their annual reports.

A banana price war between large supermarkets, which often sell the fruit as a loss leader, has hit profit margins for distributors. Large retailers are also using their purchasing power to force producers and distributors to absorb cost increases, which have been made worse by poor weather and crop diseases. Supermarkets are also increasingly sourcing their bananas directly from producers, damaging distributors' revenues, said Alistair Smith, a campaigner for social and environmental issues relating to the supply of bananas. In the UK, such direct sourcing accounted for more than half of the bananas traded. Smith said "The current low prices are not sustainable for the industry. They are damaging the industry and the people who work in it. The industry has been suffering from overcapacity for the past few years, so a merger of the two major players should resolve some of the volatility in the market."

(a) With reference to Extract 1, explain **one** condition necessary for the existence of monopsony power.

(4)

(b) Evaluate the likely effects of supermarkets' monopsony power on banana **distributors**.

(8)

Extract 1 (continued from last slide)

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Announcing the proposed merger, Ed Lonergan, Chiquita's Chief Executive, said: "We have always identified Fyffes as a fantastic partner. The tie up makes particular sense now as the banana market is the most competitive I have ever seen – there are so many players bringing bananas into every port in the world."

A merger is likely to give the combined company more negotiating power with suppliers, although the Fairtrade Foundation warns that the merger would only squeeze banana growers further. The merged company would have combined sales of $4.6 billion. It would distribute about 160 million cases a year in total, compared with 117 million at Del Monte and 110 million at Dole.

Chiquita is the larger company, with annual revenues in excess of $3 billion compared with $1.5 billion at Fyffes. The merged company would have the scale to negotiate better deals with retailers. Chiquita and Fyffes hope to achieve $40 million a year in pre-tax cost savings while gaining share in the melon, pineapple and packaged salads markets. Savings will come from logistics, for example putting more bananas on to fewer boats.

The high profile of these brands makes it likely that regulators will scrutinise the proposed merger as the new company would have almost 30% of the European market.

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Question Number	Answer	Mark
9a	Theory: 2 marks. Award **one** condition for up to 2 marks. 1 mark for identification and 1 mark for explanation. Conditions might include: • A powerful buyer in the market drives down the prices of supplies. Buyers are price makers. Large buyers with market power, small or competitive sellers which are price takers/low level of market power. (1+1) • Sellers do not have the power to determine prices. Sellers are price takers. Firms selling products cannot sell to other buyers. (1+1) • There are barriers to entry for firms wishing to buy products. (1+1) Application related to monopsony: 2 marks. At least one mark must relate to the data provided in Extract 1.	

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Sense of large powerful supermarkets buying power:
The middlemen or distributor's profits are being squeezed to 3% (1), distributors' price squeeze (1) and mergers of distributors are necessary to ensure the firms' survival (1) supermarkets are so powerful that can now source direct (1)
producers/distributors have had to absorb cost increases (1)
bananas often sold as loss leaders (1)

Sense of many producers:
Global banana production has doubled Ext.1 (1)
there are lots of sellers e.g. Extract 1 'more competitive than ever' (1)

Sense of large powerful buyers (distributors):
Dole has 26% of market of distributors (or similar from Fig. 2) Deal to create largest biggest distributor (1) $1bn merger (1)

Question Number	Answer	Mark
9 (b)	KAA 4 marks (2+2 or 3+1 for effects, plus application marks) Award the best two effects. Effects might include: • Monopsony forces down prices. Distributors cannot make significant profits • Consumers have lower prices • Supermarkets may bypass the distributors by going straight to suppliers with consequent effect on distributors. • Distributors have to merge, cut costs, diversify, collude, merge to stay in business e.g. Chiquita and Fyffes (might count as 2 points) • Diagram may be awarded but not required (1+1) one mark for correct movement and one mark for impact	

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Evaluation 4 marks (4+0 or 2+2 or 3+1)

Points might include:

- Fair Trade (synoptic element)
- Consumers might be faced with less choice or higher prices in the long run
- Mergers will enable banana distributors to fightback
- has been made worse by costs increasing at the same time
- compounded by other factors making it worse for them
- depends on what else they distribute e.g. melons and pineapples Extract 1
- SR v LR - situation could improve in the future
- SR v LR - market could become more regulated to improve the situation

Extract E: British milk from British cows

Milk is the single largest part of the UK agricultural sector by value of output. Almost all the milk in the UK is purchased by just six major processors who then sell on to a market dominated by five or six large supermarket chains. UK dairy farmers complain that while they have to act competitively as price takers, there is a combination of some degree of monopsony power and oligopoly standing between the farms and the public. They claim that dairy processors have too much power when they buy milk from the farms and, in turn, the market for the processors' output is dominated by the buyers working for large, powerful supermarkets, which then sell to the public as oligopolists.

The supermarkets argue that British producers are in a weak position because alternative sources of cheap milk are available for import. The farmers claim that this argument is unsustainable because, if they were forced into bankruptcy, consumers would have no alternative but to buy imported milk which would no longer be offered at low prices.

In 2013, there were concerns about complicated supply chains across Europe resulting in a lack of traceability in meat products, leading to problems such as supermarket beef burgers containing horse meat. If more dairy farms go out of business, similar problems might occur with milk.

Sources: news reports and government information, 2013

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Explain the distinction between 'monopsony power' and 'oligopoly' (**Extract E**, line 5) **and** analyse how the market power of supermarkets can affect the profitability of dairy farms.

[10 marks]

Explanation For defining/distinguishing, for example between monopsony (a single buyer) **(2 marks)** and oligopoly (competition among a few sellers) **(2 marks)**. **See note * below**	**Up to 4 marks**

Analysis of the effects on profitability: Award 1 mark for each step in a logical chain of reasoning. **For Example:**	
• Monopsony: profitability depends on costs and revenues **(1 mark)** while firms face rising costs (**1 mark**), changing with market forces **(1 mark),** revenues may be depressed by uncompetitive practices by dominant buyers **(1 mark)** in the supply chain. Perfect competition theory assumes a large number of buyers and sellers **(1 mark)** buyers and sellers reach an equilibrium price through market forces **(1 mark)** and no individual buyer or seller is able to influence price by their own actions**. (1 mark)** Monopsony swings the balance of power from the sellers to buyers **(1 mark)** who are able to bid down the price **(1 mark)** since buyers know that sellers have fewer alternatives **(1 mark)**. • Oligopoly: Price seeking behaviour, price stickiness, etc on the part of supermarkets, and their effects on producers further along the supply chain. • The power exerted by a handful of supermarket buyers • Answer can address the profitability of farms or dairies (processors) or both.	
Up to 8 marks for the analysis	
Make appropriate use of diagrams, eg demand curves related to monopsony/oligopoly.	**Up to 2 marks per diagram (1 mark for labelling, 1 mark for correct information shown) to a maximum of 3 marks.**

Maximum of 6 marks for the analysis if the explanation has not been attempted.

***NOTE**
Explanation: allow 2 definition marks here if monopsony is defined in terms of labour markets.
Analysis: However, the subsequent analysis should deal with product markets, as this is the focus of the data