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## Case 2.2

# Shall we put up our price?

## Competition, price and revenue

When you buy a can of drink on a train, or an ice-cream in the cinema, or a bottle of wine in a restaurant, you may well be horrified by its price. How can they get away with it?

The answer is that these firms are *not* price takers. They can choose what price to charge. We will be examining the behaviour of such firms in Chapters 5 and 6, but here it is useful to see how price elasticity of demand can help to explain their behaviour.

Take the case of the can of drink on the train. If you are thirsty, and if you haven't brought a drink with you, then you will have to get one from the train's bar, or go without. There is no substitute. What we are saying here is that the demand for drink on the train is inelastic at the normal shop price. This means that the train operator can put up the price of its drinks, and food too, and earn *more* revenue.

Generally, the less the competition a firm faces, the lower will be the elasticity of demand for its products, since there will be fewer substitutes (competitors) to which consumers can turn. The lower the price elasticity of demand, the higher is likely to be the price that the firm charges.

When there is plenty of competition, it is quite a different story. Petrol stations in the same area may compete fiercely in terms of price. One station may hope that by reducing its price by 1p or even 0.1p per litre below that of its competitors, it can attract customers away from them. With a highly elastic demand, a small reduction in price may lead to a substantial increase in their revenue. The problem is, of course, that when they *all* reduce prices, no firm wins. No one attracts customers away from the others! In this case it is the customer who wins.

### Question

1. Why might a restaurant charge very high prices for wine and bottled water and yet quite reasonable prices for food?
2. Why are clothes with designer labels so much more expensive than similar 'own brand' clothes from a chain store, even though they may cost a similar amount to produce?

## ANSWER

A restaurant might charge very high prices for wine and bottled water and yet quite reasonable prices for food because they are not the price takers. Besides they are playing the role of price maker and this is actually what they not suppose to do but it's the organization's behaviour which is basically to gain profits.

A restaurant's main goods or product is foods. Therefore they are selling foods at quite reasonable price. But in the case of wine and bottled water, it's far away from their main goods or products which they are trying to maximize the profit as they do not worry about the demand that might be decrease of the high price.

In this case, the restaurant is using their food product to increase demand while drinks are just being optional. When this kind of situation occurs, after a person had the food he will be thirsty to drink while they won't be given to bring foods from outside. So, indirectly the customers are forced to buy the drink at the high price it self.

The restaurant it self behave this way to get more revenue from the sales of the drink. While their rule which is not allowing drinks from outside is making them to be the price-maker. While customers are not given an alternative as there is no competitor in the restaurant for the sales of drink where there is no substitute.

The price of the wine and a bottled drink will definitely won't affect the price of the food. But the elasticity of demand for the wine and bottled drink will not affect the price at any chance. Besides, the lower the price elasticity of demand, the higher is likely to be the price that the firm charges.

It's a very clear cut that the organization which is the restaurant behave it self to maximize profit from the no-substitute product to gain more revenue.

Clothes with designer label so much more expensive that similar 'own brand' clothes from a chain store although they may cost a similar amount to produce. This is because of the publicity that the designer label had gain based from advertisement or high sales. To increase the brand to be known well by public, they designer will put advertisement in any way to let the public reach or know the designer brand. Wile this being an advantage for his to cut through the current market.

The reason that they may use is to cover up the cost of the advertisement. Actually it is not. It's the organization or designer's behaviour to take advantage or take control over the situation and learning more revenue from the advertisement the product had gained. When

'A' brand and 'B' brand compared in market, if they 'B' is well known and had many sales, it will be main choice for the customer. Furthermore the substitute is low. They control the situation to be a price maker as long as the consumers are willing to buy the brand which is the designer label.

In another word, the consumers are not given the option as they always looking for branded and well known products. The consumers will be willing to buy the designer labels although it's more expensive as long as the designer label is well known on the current market.

## Case 2.3

# Income Elasticity of Demand and the Balance of Payments

## A problem for certain developing countries

When people are poor, they have to spend a large proportion of their income on basic goods such as food. As they get richer, so they can afford to buy an increasing proportion of luxury goods. This means that the income elasticity of demand for basic goods is likely to be low: their demand only rises slowly as incomes rise. The income elasticity of demand for luxury goods, on the other hand, is likely to be high.

This has important implications for international trade. If a country exports basic goods with a low income elasticity of demand, and imports luxury goods with a high income elasticity of demand, it is likely to run into long-term balance of payments problems.

As it grows richer, its demand for imports is likely to grow rapidly. As the rest of the world grows richer, however, so the demand for the country's exports is likely to grow slowly.

This has been one of the problems facing many developing countries. As exporters of commodities such as rice, sugar and tea, they have found that the demand for their exports has grown relatively slowly. As importers of manufactured products, however, their imports have grown relatively rapidly.

This affects their *terms of trade*. The terms of trade are the average price of a country's exports divided by the average price of its imports. If the demand for exports grows only slowly relative to imports, so the price of exports is likely to fall relative to imports: the terms of trade will deteriorate. More will have to be exported to buy the same quantity of imports.

Between 1980 and 2000, the price of (non-fuel) commodities fell by 51 per cent, compared with world prices generally. The price of manufactured products imported from the major industrialised countries, by contrast, rose by 40 per cent. This represented a substantial deterioration in the terms of trade for many developing countries.

A word of caution: income elasticity of demand is only *one* factor influencing the level of a country's imports and exports, and only *one* factor determining its terms of trade.

### **Question**

Would you expect the demand for developing countries' raw material exports to grow more rapidly or slowly over time? Does their growth give a good indication as to their income elasticity of demand?

## **ANSWER**

The demand for developing countries' raw material exports to grow more rapidly over time. The reason is, developing countries will most of their raw materials for their internal use. Which means they are not willing to increase the export of raw materials while putting in back to the nation as internal resource to promise its development. A developing country will have a very high demand for the raw material within its nation. Therefore, there is no needs for the country to export their raw material which was produce in their state to another state. The country will decrease its raw material exports and flow the raw material in to the country. This situation will make the export of raw meterial decrease while the demand for it will be oppositely increasing. Nothing to be surprised as a demand of the raw material will increase as the export decrease.

Besides, this growth will give a good indication as to their income elasticity of demand.

## Case 5.4

# The Followers of Fashion

## Technology and costs

For many products, style is a key component to their success. Two such products are clothing and cars. Both markets exhibit 'Fashion price cycles'. In recent times, however, whereas seasonal price variations for clothes have become more pronounced, those for cars have diminished. The extract below, taken from *The Economist* of 23 December 1995, explores the factors affecting the price of fashion products, and in particular looks at the role of costs.

According to standard economic theory, Giorgio Armani, a world-famous Italian fashion designer, runs a simple business. His company combines inputs of labour (seamstresses), capital (dyeing and weaving machines) and raw materials (cloth) to make clothes with the best possible trade-off between cost and quality. He then calculates what the demand is for his designs, and estimates how many units he can make without marginal costs exceeding marginal revenues. He sells these at the market-clearing price, and earns just enough profit to compensate him for his investment of time and money.

The flaw of this stylised view is that it ignores the most important thing that designers such as Mr Armani sell: fashion itself.

The article observes that the prices of fashion-sensitive goods, such as clothing and cars, follow well-established 'fashion cycles'. At the beginning of the season, prices are set at a high level. Then, as the season progresses, prices gradually fall, only to rise again as new styles are introduced for the next season.

... The main reason for this is uncertainty. When producers introduce a new line they do not know how successful it will be. To avoid selling it for less than is necessary, they initially set a high price, then lower it for lines that do not sell well. A good way to measure the importance of fashion, therefore, is to look at the variation in seasonal prices.

Over the past few decades, seasonal price variations for women's clothing have become more pronounced. However, prices in the American car market, which also tend to follow a 'fashion' cycle, have displayed the opposite trend.

The explanation for these differences, claims the article, is to be found in changes in technology in the two industries.

... Advances in the textile industry, such as the development of sophisticated electronic weaving, have made it cheaper for designers to revamp their lines each season. But in the car industry, it has become more costly to make radical style changes each year. Although new technology has made it easier to change the size and shape of a car's body, the costs of doing so as a share of the total production costs have actually risen.

### **Questions**

1. If consumers are aware that unsuccessful lines of clothing will fall in price as the season progresses, why do they buy when prices are set high at the start of the season? What does this tell us about the shape of the demand curve for a given fashion product (i) at the start, and (ii) at the end of the season?
2. What has happened to fixed costs as a proportion of total costs in the production of cars? How has this affected car design strategy?
3. How might we account for the changing magnitudes of the fashion price cycles of clothing and cars? What role do fixed costs play in the explanation?

## ANSWER

The consumers prefer to buy clothes at the beginning of the season. This is because, they prefer to mention the fashion rather than the price. They buy it at the start of the season because they don't want to miss out the fashion. Fashion is about a style that lives for a season and following the fashion growth had become a trend and most peoples prefer to be so. The fashion is just another word for time-cycle. Where means it is not for long. The shape of the demand curve for a given fashion product will be very high at the beginning and decreases as time pass by. Finally, at the end of the season, the demand will be very low.

In the production of cars, the fixed costs had increase as the technology chances. The demand for new style, new fashion, and new shaped cars had role to a need for technology to be increase in the car manufacturing industry. This increases the amount of fixed cost and the total production of the car had also increased. The affect in car design strategic is very clear. New cars are produced every time with a high price, and while the price is dropping as time goes by, to recover the and avoid a loss, the manufacturers will release new designed cars. This is their stretegic. They will be preparing for the next release although the current release card had hit the market and boost sales. This is preparation to cover up from losing their profit in car sales. Just after the price for the currently released car started to decrease, they will release another new car which suits for the current technology advances and name it fashion. This makes the car industry to control and manage the fund flow in their industry without losing in sales nor profit.

Fashion price cycles of clothing and cars are changing based from a high price. The Price will be high at the beginning and decrease as time goes by. Besides, they will go lower and lower as new fashion product introduced in market while the current product is losing its fashion. The older the fashion is, the cheap the price will be. While the fixed costs is the minimum point where the product price can be. The lowest price that the product can go is to the average of the fixed cost.