J2 June Intensive Revision

**CSQ – Lesson 3 – Cost of Production/Market Structures – Q1**

**Supermarket development and competition**

**Extract 4: China’s supermarkets present export opportunity**

Rising incomes and an expanding urban middle income group setting the stage for China's "development as a market for imported goods. Until recently, many foreign exporters considering" the Chinese market were discouraged after encountering a fragmented market made up of thousands of old-style family owned shops, open-air markets and inefficient systems for the distribution of imports. The good news for food suppliers is that 'supermarketisation' is transforming China's food sector into a modern retail system. Modem supermarkets and hypermarkets - retail formats nearly non-existent in China in the early 1990s - have now captured an estimated 30% of the urban food market and are growing at rates of over 30% annually. Chinese supermarkets grew from just one outlet in 1990 to approximately 60 000 stores by 2003.

Supermarkets began developing in China in the early 1990s, encouraged by local governments. Multi-national chains from Europe, Japan, Hong Kong and the United States provided a second major impetus in the development of the sector in the mid 1990s. They have about 40% of the sector's sales but domestic companies such as *Lianhua* and *Hualian* have developed quickly. Local governments are actively encouraging the transition to supermarkets by shutting down traditional street markets and in some cases converting them into supermarkets. In 2004, China's Ministry of Commerce announced a five-year plan to develop a rural retail network of supermarkets in small towns.

Imported foods, until recently a rarity in China, are now widely available in Chinese supermarkets. China's growing middle class has the purchasing power to afford imported food but this crucial market segment has been kept largely out of reach of the world's food exporters by the combination of China's old-fashioned marketing system and high trade barriers. However, China has cut tariffs, import trading licensing requirements and state trading monopolies as a result of Its entry into the World Trade Organisation in 2001. Lower trading barriers are the first step to opening the Chinese market, but a competitive, efficient domestic marketing system is necessary to get imported products from entry points to the Chinese consumer. That's where supermarkets come in.

*Source: Fred gale and Thomas Reardon, Asia Times,* 24 June 2005

**Extract 5: Let China’s retail wars begin (nature of competition)**

In keeping with the conditions for China's membership of the World Trade Organisation, China has lifted most restrictions on foreign retailers. Gone are the limits on the number of stores, rules confining them to large cities and regulations capping the foreigners' stake in local ventures at 65 %. China erected those hurdles to give its own companies a chance to copy the West's big store model - and they have done so with great success. The top four retailers in the country are run by the government or local entrepreneurs. But the foreign companies are not far behind and they have big plans for expansion now that the barriers have come down. Paris-based Carrefour has some 240 stores in China, and plans to open as many as 150 more this year. Its 2003 sales of US $1.8 billion made it China's fifth biggest retailer.

Consolidation is sweeping the sector, too. Shanghai Ballion, which has nearly 5000 stores, has won permission to take over four rivals. Beijing's ultimate goal is to create a small number of big players that will be strong enough to compete with the multinationals at home and expand overseas. (mergers and acquisition)

*Source: Business Week online,* 17 January 2*005*

**Extract 6: Supermarkets in the UK: a model for China’s retail sector? Tesco may have to sell off stores**

Tesco, the UK's biggest-supermarket group, may be forced to sell off some of its shops in what would be a dramatic intervention aimed at curbing the retail giant's dominance. There is a call for government regulators to intervene to force Tesco into **divestment,** the process of selling off stores. (reduce market power)

(the government regulate the firm to be become smaller – avoid the negative impact of large scale production on the society – pressure on small firms to sell off the business -this leads to market dominance – consumer exploitation)

The UK's top four supermarkets have a huge market share which is continuing to grow in the next ten years Tesco could have 1200 smaller convenience stores in addition to its large supermarkets. Asda, one of Tesco's major competitors, is poised to follow suit Ten years ago supermarkets did not compete in the smaller convenience store market. In the four years to 2004, 7377 independent convenience shops, more than 20% of the total, closed. In addition, the buying power of the supermarkets is so great that their suppliers complain that they are forced to sell to supermarkets at very little profit.

There is certainly a case for divestment,' says the policy director at the New Economics Foundation. The market place is being strangled by the big four.' However, a spokesperson for Tesco said, 'I think the public interest would need to be looked at in a proper manner by government regulatory authorities and I would hope that when they talked to us and looked at our operations in detail they would come to the view that divestment was a bad idea'.

*Source: Observer,* 6 November 2005

Why divestment was a bad idea?

The advantages of large firm of production forgone

* The cost saving from EOS – lowering average cost of production – lower the price for consumers

**Table 4: Top four UK supermarkets: share of grocery sector**

|  |  |  |
| --- | --- | --- |
| **Share of Grocery Sector (by value of total sales)** | **2004** | **2005** |
| **Tesco** | 28.1 | 30.5 |
| **Asda** | 16.6 | 16.7 |
| **Sainsbury** | 15.4 | 15.7 |
| **Morrisons** | 13.9 | 11.3 |

*Source: TNS Superpanel -> high market concentration ratio BY THE TOP FOUR FIRMS from 2004 too 2005 -74% - 74.2% - more than 50% by top firms - oligopoly*

**Extract 7: Supermarkets in Singapore: the food retail sector**

For many years the food retail sector has been dominated by 'wet markets1 and general grocery shops, but this pattern is changing with the rapid expansion of modern supermarkets. NTUC Fairprice and the Dairy Farm Group are the two largest supermarkets for retail food. Cold Storage and Shop n' Save supermarket chains are subsidiaries of the Dairy Farm Group.

Wet markets still represent the bulk of sales of products such as vegetables, seafood, rice, eggs and chicken, while dedicated fruit shops still sell most of the fresh fruits. However, supermarkets are gaining market share in all retail food products.

Singapore has a significant domestic industry manufacturing a range of food and beverages, but virtually all raw materials are imported, as there is almost no local agricultural production. Singapore's multi-racial society and the presence of a large expatriate population have led to a diverse and rich variety of food types being available to customers.

*Source: Australian Government: Austrade, Guide to Australian Exporters Webpage 2005*

**Table 5: Singapore retail sector: retail sales index for selected types of outlet**

|  |  |
| --- | --- |
| **Type of Outlet** | **Index at Current Prices (1997 = 100)** |
| **2000** | **2001** | **2002** | **2003** | **2004** |
| **Department Stores** | 104.3 | 99.9 | 100.4 | 99.6 | 108.4 |
| **Supermarkets** | 123.0 | 138.3 | 147.1 | 158.5 | 151.1 |
| **Provision and Sundry Shops** | 100.6 | 104.6 | 109.6 | 113.8 | 123.2 |
| **Total retail sales** | 128.4 | 133.1 | 129.8 | 140.9 | 158.6 |

 *Source:* [www.singstat.gov.sg](http://www.singstat.gov.sg)

ACCOUNT FOR THE TREND :

1. *GROWTH IN POPULATION WILL INCREASE THE DEMAND FOR NECESSITIES AND BASIC GOODS – EXPAND THE NEED FOR SUNDARY SHOPS AND SUPERMARKETS*
2. THE GROWTH OF THE ECONOMY AND THIS WILL LEAD TO RISE OF INCOME – LEADS TO PURCHASE OF CONSUMER GOODS

**Questions**

(a) Compare the change in retail sale in Singapore by type of outlet between 2000 and 2004. [2]

(b) Explain two reasons why supermarkets "are growing so quickly in China. [4]

(c) (i) Describe the type of market structure operating in the UK grocery sector in 2004. [2]

(ii) Explain how the firms in this market might compete against each other. [4]

(d) Discuss the policy of divestment in the case of Tesco explaining clearly how this might affect consumer welfare. [8]

(e) In the light of the data provided, if you were an economic advisor to the Singapore government, would you recommend that it should follow the example of the Chinese authorities and encourage supermarket development? Justify your answer. [10]

**[Total: 30]**

**Suggested Answers**

1. **Compare the change in retail sales in Singapore by type of outlet between 2000 and 2004. [2]**
* **Overall trend**
* **Pattern of trend – comparison with other components.**

In general, the retail sales for the three types of outlets have increased from 2000 to 2004. The retail sales for Supermarket and Provision and Sundry shops have increased from 2000 to 2004 while the retail sales index for Departmental Stores has fallen from 2000 to 2003 and risen again in 2004.

In general, the retail sales for the three types of outlets have increased from 2000 to 2004. The increase in retail sales for Supermarket is higher than the Departmental Stores and Provision and Sundry shops.

1. **Explain two reasons why supermarkets are growing so quickly in China. [4]**

(growth in terms of revenue or output) – supermarket is based on revenue

* Sales revenue (why the revenue will increase?)
* I) increase in demand
* Ii) increase in supply – increase in demand must be greater than increase in supply
* Increase in supply – price will fall – PED is price elastic (TR ncreases)

The growth of the supermarket in China or “supermarketization” can be understood by examining the demand and supply factors that influence this market.

From the demand aspect, the rise in income is one factor that will lead to a rise in purchasing power which will increase the demand for goods in the supermarket. The “expanding middle class” in China will also influence the taste and preference of the consumers, opting for new supermarkets which are air-conditioned and contain more foreign-imported which are favored by the more affluent consumers.

From the supply aspect, there are also more suppliers in the supermarket industry as ‘multi-national chains from Europe, Japan, Hong Kong and the United States’ are entering China’s supermarket industry. Furthermore, the government is also encouraging more ‘domestic companies such as *Lianhua* and *Hualian*’ to develop as the government has announced the development of ‘a rural retail network of supermarket in small towns’. Additionally, the government is encouraging more foreign firms to participate in the supermarket industry by relaxing the rules in curbing the number of retail shops and region of operation for foreign firms and thus, encouraging more producers in this industry.

Thus, both the increase in demand and supply in this supermarket industry in China will generate a higher level of growth and development.

**ci) Describe the type of market structure operating in the UK grocery sector in 2004. [2]**

It is an oligopoly. The market concentration ratio in this UK grocery sector is at 74% and 74.2% for 2004 and 2005 respectively occupied by the top 4 firms. Furthermore, in this grocery sector, there are extensive internal economies of scale to be reaped for the big firms, creating barriers to entry to reduce competition as seen from the closure of 7377 independent convenience shops within 4 years to 2004.

Characteristics of oligopolistic market structure

* High degree of mutual interdependency
* Imperfect market mobility and information about price and cost of production
* High degree of BTE – high degree of market power
* Price collusion and price rigidity – non-price competition (mergers and acquisition, R&D) / brand loyalty cultivation
* Capacity to reap EOS and conduct price discrimination

**cii) Explain how the firms in this market might compete against each other. [4]**

In this market, the firm is likely to compete through **non-price competition** like advertising and promotion as the firms face a condition of price rigidity due to high degree of mutual interdependency. Under this situation, the use of price strategy will not give the firms advantage in terms of revenue or market share.

**Why the firms will not conduct price competition?**

 When the firm decreases price, the competitors will also decrease price due to the need to prevent the loss of customers, contributing to a small percentage of increase in quantity demanded for the firm and the demand curve is price-inelastic. On the other hand, when the firm increases price, the competitors will not increase price, expecting the gain in new customers and thus, there will be a large percentage decrease in quantity demanded and the demand is price-elastic. Under such circumstances, the firm sees no gain in price reduction and increment. Hence, the price strategy is of no use.

 **Why the firms will conduct non-price competition?**

 As for non-price competition like advertising and promotion, it will cultivate consumer loyalty, allowing the firm to avoid price competition. As the consumers create a higher degree of necessity of demand and willingness to substitute the goods by the firm due to advertising and promotion, the demand curve will become price-inelastic. This will allow the firm to increase the price to raise revenue as the increase in price of the goods concerned will lead to a less than proportionate decrease in quantity demanded and thus, the gain in revenue due to the increase in price is greater than the loss in revenue due to the fall in quantity demanded. Therefore, the non-price strategy is more appropriate and useful.

 The firms in this market are likely to engage in mergers and acquisition as it will offer the advantages of economies of scale in procurement, financial and commercial activities. Consequently, this will help the firms to lower cost of production to enable the firms to lower the price to raise price competitiveness. Through mergers and acquisition, the firm will be able to increase market share to gain greater market power to create barriers to entry to prevent competition. Hence, the gain in market power will enable the firms to decrease price to raise market competitiveness.

 In retrospect, the nature of the grocery sector will make price competition a less viable choice as compared to product differentiation and mergers and acquisition, which are common forms of competitive strategy.

**d) Discuss the policy of divestment in the case of Tesco explaining clearly how this might affect consumer welfare. [8]**

consumer welfare is expressed in terms of consumer surplus – (PXQ) -decrease in price – increase in CW

 Structure of Discussion

* Meaning of divestment – cutting down the size of operation and business activities
* State that the impact on the consumer welfare can be seen from the price level, quality of the product and benefit of consumption
* Explain how it will raise the welfare of the consumers
* Explain how it will undermine the welfare of the consumers
* Evaluation of the impact

Introduction

The call for government regulators to force Tesco to divest would mean to reduce the number of stores under Tesco so as to reduce their market dominance or market power to prevent consumer exploitation. This law will lead to price change and change in benefit of consumption which will affect the consumer welfare.

Main Body

**1. Explain how the act of divestment will undermine or benefit the welfare of the consumers.**

* 1. positive impact – raise efficiency and maintain low cost of production – able to sell the goods at low price
	2. negative impact – less stores – less convenient to the consumers

 – less choices for the consumers /reduce quality of products

– higher price due to lesser economies of scale to reaped

* Unemployment may arise

**2. Explain how the act of divestment will improve the welfare of the consumers.**

1. **State and evaluate the key factors influencing the impact**
* **How it is divested? Focusing on cutting qualities or cutting down the service operation**
* **How does it affect the operation of food and grocery supply**

**Conclusion**

**e) In the light of the data provided, if you were an economic advisor to the Singapore government, would you recommend that it should follow the example of the Chinese authorities and encourage supermarket development? Justify your answer. [10]**

**Source of Information**

Structure of Discussion:

1. **Explain the policies adopted by the Chinese government to encourage Supermarket Development (1)**

**Reduce tariff**

**Encourage MNCs to set up in China**

**Nationalize supermarkets**

**2. Explain why you would suggest that the Singapore government adopt the policies introduced by China to encourage Supermarket Development (4)**

 **Nationalize the supermarkets – introduce this with MTUC supermarkets**

* **Control the price of the basic grocery and necessity – help to keep cost of living and inflation low**
* **Employment for workers and interests of the workers**
* **Ensure the country has a stable source of food supply**
* **Ensure the stability of the supermarket business – government can extend support to business operation in terms of logistics**

**Encourage the MNCs to set up the business in Singapore**

* **Size of market is small**
* **Products sold by foreign firms may not be suitable**

**Reduce tariff – we do not have tariff / cannot provide subsidy to encourage imports / reduce the cost of imports by raising exchange rate**

1. **Explain why you would not advise the Singapore government to adopt these policies or state the detrimental impacts that the Singapore government needs to take note of (4)**
* **Singapore is very small country, has no tariff to incentivize the importers, foreign supermarket operators may not be suitable for Singapore**
* **Best solution is to nationalize the supermarkets or linked to government institutions**