

CHAPTER 1

INTRODUCTION

1.1 Background Issues

One of the major area of research in the field of microeconomics has been the study of market structure and its relation to the performance of firms. In standard micro theory, firms are price takers and earn only normal profits in perfectly competitive markets. Conversely, the monopoly firm is a price maker and earn supernormal profits. The Structure-Conduct-Performance paradigm attempt to link market structure and profits earned by firms.

The contestable market hypothesis however suggests that the link between market structure and performance may be less dominant¹. A monopolist may not be able to earn supernormal profits by charging high prices because such a situation would attract the entry of new firms into the market. Thus, the threat of entry (potential competition) limits the monopolist's ability to earn supernormal profits. Despite the intuitive appeal of the contestable market theory, it has come under severe criticism especially for its assumptions².

¹ The contestable market model was proposed by Baumol, Panzar and Willig (1982).

² One major weakness of the model is the assumption of no sunk cost.

Although debate on the postulates of the SCP paradigm is still ongoing, there is a current interest among economists to incorporate microfoundations of macroeconomics issues. One example is to examine the link between the micro variables of market structure and inflation.

Means (1935), suggested that the greater the concentration of industries, the less flexible the price levels. Economic theorists have found it difficult to formalize Means's hypothesis on the relationship between market structure and inflation³. Despite the theoretical problems, several empirical studies were carried out to link market structure to the rate of inflation⁴. However, these empirical studies were quite inadequate as the static nature of the models used were not reconciled with the dynamic nature of inflation (Domberger, 1983, p.41). To rectify for this weakness, Dormberger (1979 and 1983) adopted a partial adjustment mechanism model which was used to link market structure to the rate of price adjustment. His studies supported a positive correlation between market concentration and the rate of price adjustment. Domberger's empirical results suggested that: "industrial concentration, by raising the speed with which firms react to cost increases, could contribute to the inflationary problem in the United Kingdom"⁵.

³ Assumptions such as "representative firms" are homogenous in the economy have to be made.

⁴ Weiss (1966), Philips (1971), Dalton (1973), and Lustgarten (1975).

⁵ Domberger (1979).

To our knowledge, there has been no empirical studies that have been attempted to examine the link between market structure and price adjustment. The importance for such a study has been pointed out by the Bank Negara Malaysia (BNM)(1993). BNM pointed out that the increase in the rate of inflation rate in the country could be partly attributed to the market structure in the manufacturing sector. BNM further suggested that a more competitive market can ameliorate inflationary pressures in the economy. However, no known empirical evidence is available to support these statements. This study therefore aims to see if there is a link between market structure and price adjustment in the Malaysian manufacturing sector.

1.2 Organisation of the Study

There are two major components of the study. First, the empirical evidence on the relationship between market structure and performance in Malaysia's manufacturing sector from 1985 to year 1992 is examined. Attempts are then made to test the relationship between market structure and the rate of price adjustment in manufacturing sector. The organization of the study is as follows:

Chapter 2 describes the structural changes in Malaysia's economy after 1957. This puts in perspective the emergence of the manufacturing sector as an

important sector in the Malaysian economy. Chapter 3 reviews the empirical studies on the postulates of the structure-conduct-performance paradigm. It also examines existing studies on market structure and the rate of price adjustment. Chapter 4 discusses the Structure-Conduct-Performance (SCP) paradigm. In Chapter 5, the theoretical model and empirical evidence on the relationship between market structure and the rate of price adjustment (in Malaysia's manufacturing sector) is investigated. The final chapter summarises the findings of the study and makes some policy recommendations.