2017 H2 Prelim Paper 2

2 In July 2017, giant e-commerce player, Amazon, launched its Prime Now services in Singapore. Prime Now allows Singapore users to place online orders through its phone app, for same day delivery on a range of retail items from food to electronic to baby products.

(a) Explain why the retail market in Singapore is contestable. [10]

(b) Discuss the extent to which large firms in Singapore's retail market is better able to survive the entry of new competitors such as Prime Now as compared to smaller firms. [15]

Part (a)

Introduction

A contestable market exists when there are low barriers to entry and exit such that new competitors can enter the market. For a perfectly contestable market**,** entry into and exit out is costless. This means there are no barriers to entry and no barriers to exit, such as sunk costs and contractual agreements. A contestable environment is common in most industries, including retail markets, even when there appears to be one or more dominant businesses with significant market share.

The factors to consider in determining contestability of a market include how costless entry and exit is, low consumer loyalty and access to technology.

Costless entry and exit

Costless entry and exit increases the contestability of the market. Barriers to market contestability exists when there are strong barriers to entry and existence of sunk costs i.e. cost that have been committed to a business and cannot be recovered once a firm chooses to compete. If there is however costless exit condition, it reduces the risks of entering a market since firms will not incur significant cost even if they are not successful. Potential entrants can operate a 'hit and run strategy', which means that they can 'hit' the market, given there are no or low barriers to entry, make profits, and then 'run', given there are no or low barriers to exit.

Unlike other industries, like those in manufacturing, the retail market in Singapore is less capital-intensive and technology-intensive. For example, the financial resources required for the infrastructure, machinery, R&D and advertising in starting up a fashion boutique or grocery shop is lower as compared to that required in setting up a firm producing manufactured goods as the most significant cost in setting up a retail store is likely to be the rental and renovation cost. In the case where the retailer does not need to store their stocks in advance, it can even cut down on inventory cost. Given the low initial capital outlay, the penalty for leaving the market in terms of the foregone capital investment is lessen. Hence, entry and exit becomes less costly in the retail market, making it more contestable.

Low consumer loyalty (for existing firms)

The retail market in Singapore is characterised by low consumer loyalty. This ensures that price becomes determining factor in consumers' buying decisions. On the other hand, if an incumbent has strong consumer loyalty, then it will be difficult for a new firm to enter the market as they would have to spend a lot of funds on advertising which is a sunk cost. Even then advertising may not be sufficient to change customer loyalty to very strong brands.

While the level of customer loyalty of consumer loyalty is dependent level of product differentiation in the market, it is likely to be lower for retailers compared to firms producing a good or service. Huge advertising and R&D expenditure by manufacturers from sportswear to electronic gadgets have the effect of differentiating their products and made consumers have become more attached to their brands. Hence reducing the value of cross elasticity of demand for their products, making the demand for their products less responsive to price reductions from their competitors. On the other hand, retailers usually do not incur such large scale expenditure to differentiate themselves and their means of differentiation tends to be limited. Some forms of differentiation can include the quality of the service and type or range of products they offer for sale. For example, the firms in the grocery market in Singapore are differentiated in different aspects. Some specialise in good quality meat, some on the freshness of their daily produce and some provide online deliveries. However, given the close substitutability of many of their products, the focus on the pricing of their products as a way to compete is quite commonly seen among the supermarkets in Singapore, with some even having their own house brands for the purpose of providing consumers with more value for their money.

Access to technology

The retail market in Singapore is a contestable market because there are less impediments to potential firms accessing the technology needed in the market. The relatively low cost and ease of availability of such technology means that existing firms find it hard prevent potential firms from contesting in the market. Hence, with more accessibility to technological advancement that support the development of e-commerce, potential firms not only find it easier to enter the retail market but also to compete with less resources. As e-commerce retailers, they can cut down on the start-up costs even more as compared to traditional brick-and-mortar retailers. Furthermore such technology also enable them to reach their target consumer groups and promote their products to them much more easily. In quite a number of cases, such technology even allows some smaller firms to sell their products to an international market instead of being confined to just the domestic market, boosting their revenue further and hence profits further, with little additional cost incurred.

Conclusion

In recent years, the above factors have allowed a growing number of markets and industries to become genuinely contestable and this includes the retail market in Singapore.

Suggested Mark Scheme (9757)

Level	Descriptor	Marks
L3	Clear explanation, using economic analysis, of the factors affecting contestability in the retail market in Singapore with good use of examples.	8- 10
L2	An explanation of the factors affecting factors affecting contestability in a market with some use of examples that could be applied to the context of retail market in Singapore. Descriptive explanation – max 5 No examples given in explanation - max 5	5- 7
L1	Some knowledge of factors affecting contestability with errors. Limited use of examples and little explanation.	1- 4

Suggested Mark Scheme (9732)

Level	Descriptor	Marks
L3	Clear explanation, using economic analysis, of the factors affecting contestability in the retail market in Singapore with good use of examples.	7 - 10
L2	An explanation of the factors affecting factors affecting contestability in a market with some use of examples that could be applied to the context of retail market in Singapore. Descriptive explanation – max 5 No examples given in explanation - max 5	5 - 6
L1	Some knowledge of factors affecting contestability with errors. Limited use of examples and little explanation.	1- 4

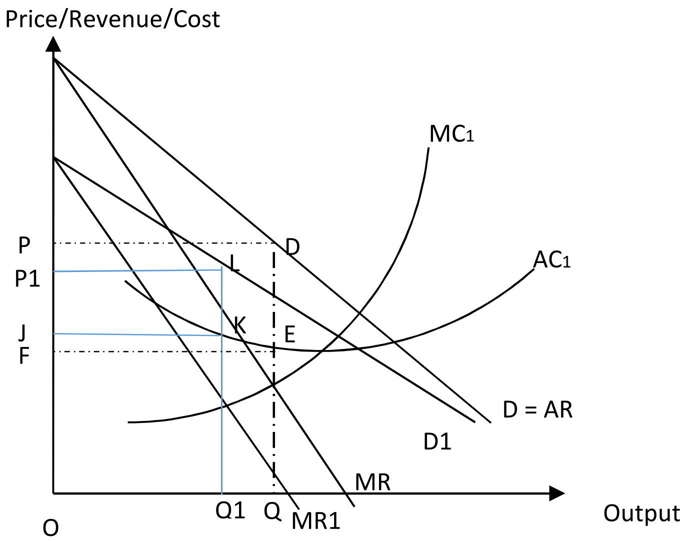
Part b

The entry of Amazon's Prime Now into Singapore is likely to pose a threat to the existing retailers due the scale its operation. One factor that affects the price, output, revenue and profitability of the firm is the size of the firms which is usually related to the degree of competition, and hence the market structure in which it operates. But other factors, like the ability of the firms to adapt and adopt alternative strategies and the nature of the product that the firms sell also impact their susceptibility to such a threat.

Thesis: Large firms in Singapore's retail market is better able to survive the entry of new competitors as compared to smaller firms

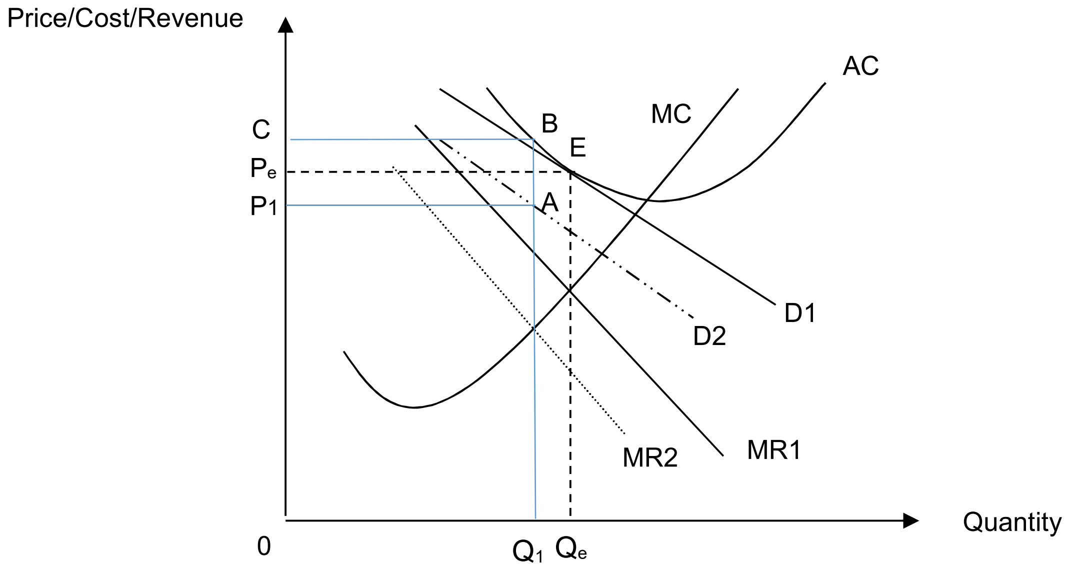
Large firms in Singapore's retail market able to survive the entry of new competitors as compared to smaller firms due to the level of profits they are likely to enjoy. Large firms enjoy significant market share and would therefore be in less competitive markets which tend to be more oligopolistic in nature. For example, the grocery market in Singapore is dominated by supermarket chains, such as Cold Storage, NTUC Fairprice and Sheng Shiong. As such, each of the supermarket chain has significant market power and its demand is more price inelastic. Due to the certain revenue and cost advantages accruing to the firm, in the form of its more established and wider network of supply and distribution as well as marketing economies of scale, it is able to enjoy greater supernormal profits even in the long run and therefore is able to survive the entrance of new competitor in the market. Suppose a supermarket earns supernormal profits as illustrated in the figure below. Being profit maximising will mean that it produces where MR=MC with equilibrium price and output at OQ and OP respectively and supernormal profits earned represented by area PDEF. With the entry of Amazon's Prime Now, demand for its product falls and becomes more elastic, for example from D to D1, and its total revenue will fall to OP1LQ1. As its TR is able to cover its TC, it is still able to enjoy supernormal profits of. Though profits are lower than before, it does not need to exit the industry. Hence, it can be seen that a large firm, is less vulnerable to threat of entry of new competitor as its chances of staying in the industry is probably higher.

.



Small firms, for example those more commonly found in monopolistic competitive markets, might have lesser ability to survive. Such markets faces greater degree of competition and are characterised by the presence of a large number of relatively small firms, each selling a differentiated product. Typically, these features can be found among the among the fashion boutiques in Singapore. Each of this firm is a price setter as it has some degree of control over its price and the demand curve is downward sloping. But due to the weaker market power, its demand curve tends to be more price elastic. With low barriers to entry, there is greater freedom of entry and exit in the industry and less revenue and cost benefits as compared to large firm, such firms might only earn normal profits in the long run.

With reference to the figure below, a monopolistic competitive firm is seen originally to be in equilibrium where MR = MC at output OQe and price OPe, where it is earning normal profit as TR = TC = area OPeEQe. With entry of a new competitor, the firm's demand curve will thus shift to the left (from D1 to D2). As a result the fall in price to OP1 and output to OQ1 at the new equilibrium means that the firm's revenue is now OP1AQ1. Since the TR is below the TC, the firm is thus making a subnormal profit of P1CBA. In the short run, the condition for the firm to shut down is whether its TR is able to cover its TVC. If TR is be able to cover its TVC and some of its TFC and the firm will continue production in the short run. However, should the demand fall more drastically and result in TR being lower than TVC, then the firm will shut down.



As firms must earn at least normal profit to continue production in the long run and firms that cannot make normal profit have to leave the industry. Hence, smaller firms are more vulnerable to closure due to the lower profit margin that these firms are able to maintain.

However, the extent to which the demand of firms are impacted are also dependent on the cross elasticity of demand of the products offered by Amazon with respect to that of those of these firms. If the products available in Amazon are close substitutes with high XED value, to those of the large firms, then the impact on the large firms' revenue and profits might be significant as well.

The impact on existing firm's demand is also on the range of products that Amazon offers as an online retailer as this is could be an important consideration for consumers when shopping online. In the short run, Amazon's range of 20,000 products in comparison to average supermarket has about 50,000 items, means that an existing supermarket is likely to have an edge and therefore better able to survive. In the long run, if Amazon broaden their range of products, it is likely to pose a big threat to the large supermarket chains' ability to survive as well.

Anti-thesis: There are other factors besides size of firms determining ability of firms to survive

(i) Strategies firms adopt
On the other hand, the ability of firms to adapt and adopt alternative strategies to survive can be important factor to determine firms' ability to survive. With greater competition, firms will need to develop strategies to prop up their profit margins.

As Amazon is an e-commerce player, the entry of Amazon is expected to pose a greater threat to existing firms using e-commerce platforms. While, the supermarket chains and consumer electronics chains such as Harvey Norman and Courts are affected, the impact is could be significant for online grocers such as RedMart and honestbee too. At the same time, with the promise of same day delivery, it is clear that Amazon is not competing on pricing of products, which is an unsustainable strategy in the long run, but rather the quality of the service, in terms of the speed of the delivery. Hence, if smaller firms like RedMart and honestbee are able to provide better quality of service, in terms of online shopping experience and delivery, they are still able to survive in the market.

It is anticipated that Amazon's entry might not have as much impact on retailers in malls, as they provide a different shopping experience. In addition, with recent changes in the retail market, there are more incentive for retailers to combine online and offline shopping experiences. This presents them with an additional channel of revenue which will enable them to earn more profits. Hence, retail firms which are able offer a better shopping experience by integrating the online and offline experience for the consumers might have advantage and still survive the competition from Amazon.

With changes in taste and preferences, changing lifestyles, the retail market is always changing. Smaller firms are said to be more adaptable to changes in market conditions and are able to better response and cater to new demands. This flexibility allows small firms to tap on growing demand in certain segments of the market faster than large firms. For example, in response to greater competition, smaller firms that try to create an edge by positioning themselves in a niche segment, like organic food, might be able earn sufficient revenue and remain profitable.

(ii) Nature of demand
While large firms may have sophisticated database, marketing and promotions, small retailers are still know their customers individually. This is important for retailers in market where personalised attention to service is required. Hence, by providing

personalised recommendations with their offerings, for example, they are better able to value-add their service to the consumers as compared to large firms. This will ensure that they are still able to maintain their demand even with the entry of new competitor in the market.

The retail market for some luxury goods may be limited due to the very high price. This is true for distinctive products like exclusive clothing and high quality jewellery, where only a small group of customers are willing and able to pay for the element of uniqueness and prestige. Despite the relatively small demand, it is sufficient to keep these small firms profitable to survive. However, only a limited number of smaller firms will be able to derive the above benefits based on the nature of the demand for their products.

Conclusion
To a large extent, large firms are less vulnerable to threat of entry of new competitor due to large profit margin they have initially as compared to small firms firms. However, it can also be seen in some cases that the ability of the firms to adapt and adopt alternative strategies and the nature of the good that the firms sell are also important in affecting their vulnerability to such a threat. Firms that are more flexible in adapting are more likely to survive. With recent changes in retail market, those firms that are able to tap on the technological advancement and changing taste and preferences more likely to withstand the threat.

Suggested Mark Scheme (9757)

	Knowledge, Application/Understanding and Analysis	
L3	A <u>developed</u> analysis, supported with the good use of examples, of the reasons why large firms in Singapore's retail market may and may not be better able to survive the entry of new competitors as compared to smaller firms.	**8-10**
L2	An <u>underdeveloped</u>, descriptive explanation of the reasons why large firms in Singapore's retail market may and may not be better able to survive the entry of new competitors as compared to smaller firms. One-sided answer – Max 7 Without the use of examples – max 6	**5-7**
L1	For an answer shows some basic knowledge of the reasons for why large firms are better or small firms can survive that are largely unexplained or one that is largely irrelevant and/or contains conceptual errors.	**1-4**
	Evaluation	
E3	An insightful evaluation that uses analysis to support a judgement on the extent that large firms in Singapore's retail market may better able to survive the entry of new competitors as compared to smaller firms.	**4-5**
E2	Some attempt at evaluation or conclusion about the extent that large firms in Singapore's retail market may better able to survive the entry of new competitors as compared to smaller firms.	**2-3**
E1	For an answer that gives unsupported evaluative statement(s).	**1**

Suggested Mark Scheme (9732)

Knowledge, Application/Understanding and Analysis		
L3	A developed analysis, supported with the good use of examples, of the reasons why large firms in Singapore’s retail market may and may not be better able to survive the entry of new competitors as compared to smaller firms.	**9-11**
L2	An underdeveloped, descriptive explanation of the reasons why large firms in Singapore’s retail market may and may not be better able to survive the entry of new competitors as compared to smaller firms. One-sided answer – Max 7 Without the use of examples – max 6	**6-8**
L1	For an answer shows some basic knowledge of the reasons for why large firms are better or small firms can survive that are largely unexplained or one that is largely irrelevant and/or contains conceptual errors.	**1-5**
Evaluation		
E2	An insightful evaluation that uses analysis to support a judgement on the extent that large firms in Singapore’s retail market may better able to survive the entry of new competitors as compared to smaller firms.	**3-4**
E1	For an answer that gives unsupported evaluative statement(s).	**1-2**