Question:

'The World Health Organisation (WHO) encourages large pharmaceutical firms to practise price discrimination internationally so as to help the improverished in poor countries. But globalization is making it increasing more difficult for them to do so due to e-commerce.'

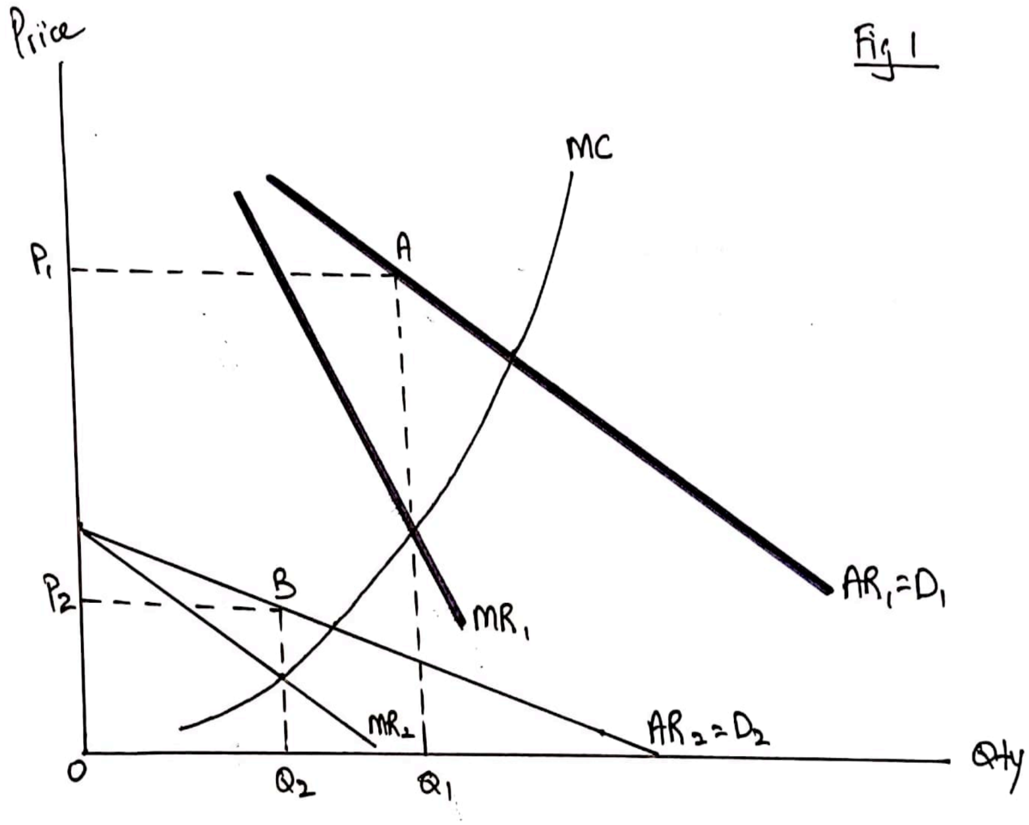
a) Explain the impact of globalization on the price and output determination of a dominant firm. (10m)

b) In the light of globalization, assess the extent a firm might decide to increase its firm size or to not price discriminate. (15m)

Specimen Essay:

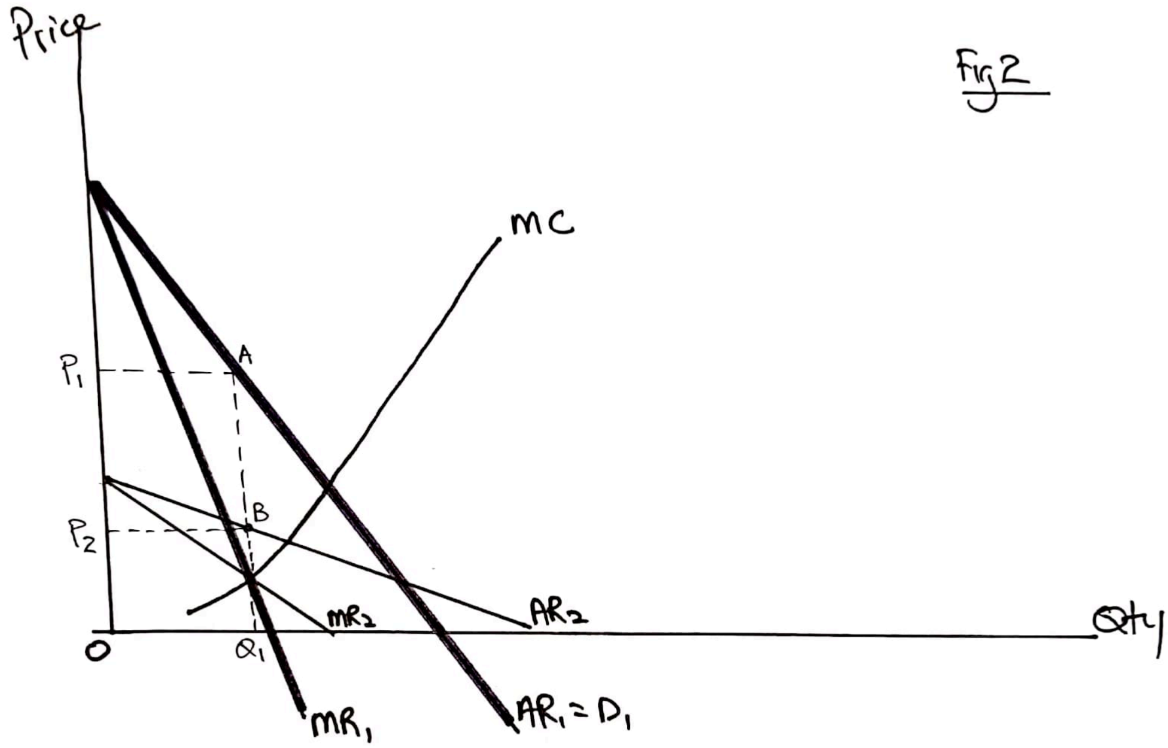
Globalisation refers to the integration of national economies into a global economy through trade, foreign investments, labour mobility and spread of technology. This lowers barriers to entry, affecting price and output determination of a dominant firm in a domestic market. A dominant firm enjoys a disproportionately large market share and high barriers to entry.

As globalization lowers barriers to entry, more international firms now enter the domestic market. This has 2 effects: firstly, the dominant firm begins to lose market share, resulting in a fall in demand. Its Average Revenue (AR) and Marginal Revenue(MR)curves fall, shifting to the left. Secondly, the entry of new firms results in increased availability of substitutes. This causes the firm's demand to become more price elastic. Graphically, the AR and MR curves now become more gentle sloping to reflect this increased substitutability. As such, there are 2 possible outcomes for the dominant firm's price and output.

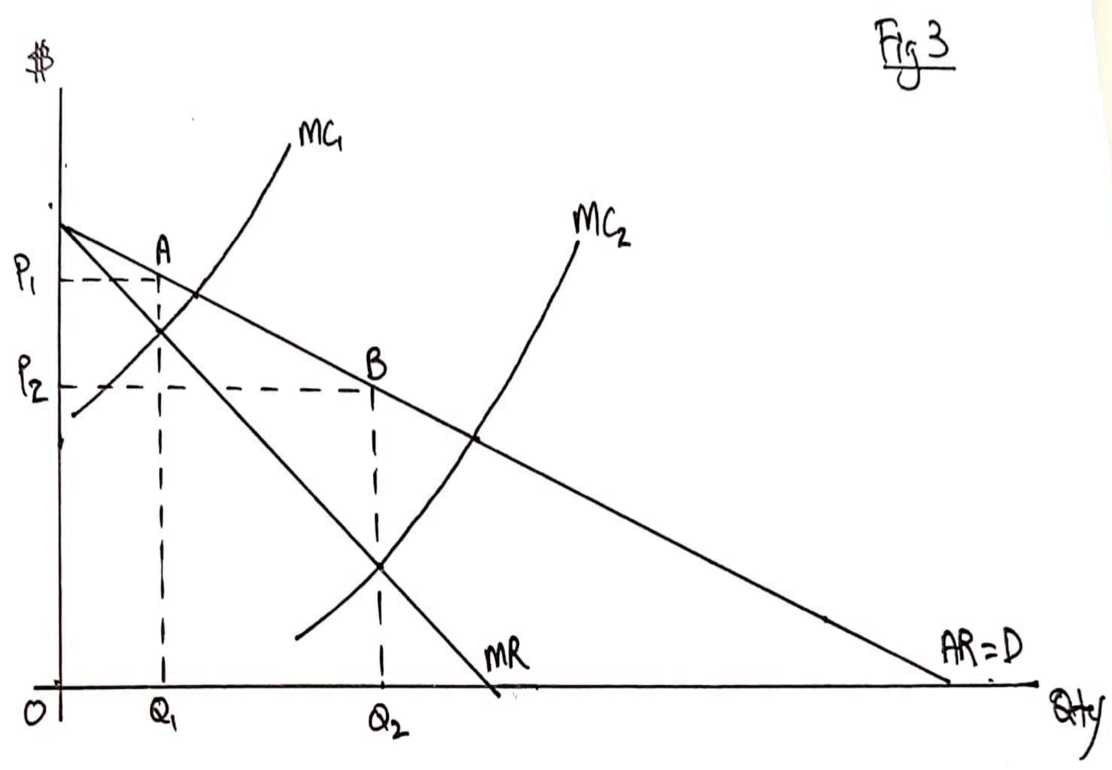


If rival foreign firms are successful in entering the domestic market, the dominant local firm will suffer a large fall in market share. Prices (P_1-P_2) and qty dd (Q_1-Q_2) will fall significantly, resulting in a large fall in TR (OP_1AQ_1) to OP_2BQ_2). This affects the firm adversely.

Another possibility is that the dominant firm is still able to retain its customer base (Q_1) due to customer loyalty, but at a lower price(P_1-P_2). Total revenue still falls (OP_1AQ_1 to OP_2Q_2) but by a lesser extent.



On the other hand, globalization enables the firm to access cheaper sources of raw materials overseas. In addition, it can also outsource its manufacturing processes to low cost producers overseas eg Apple outsources the manufacture of its iconic iPhones to factories in China. This allows the firm to enjoy comparative advantage existent in such countries (eg low labour cost)



With lower cost per unit, the firm's marginal cost falls from MC_1 to MC_2. Prices fall (P_1-P_2) but qty dd rises more than proportionately from Q_1 to Q_2. TR rises from OP_1AQ_1 to OP_2BQ_2, benefiting the dominant firm.

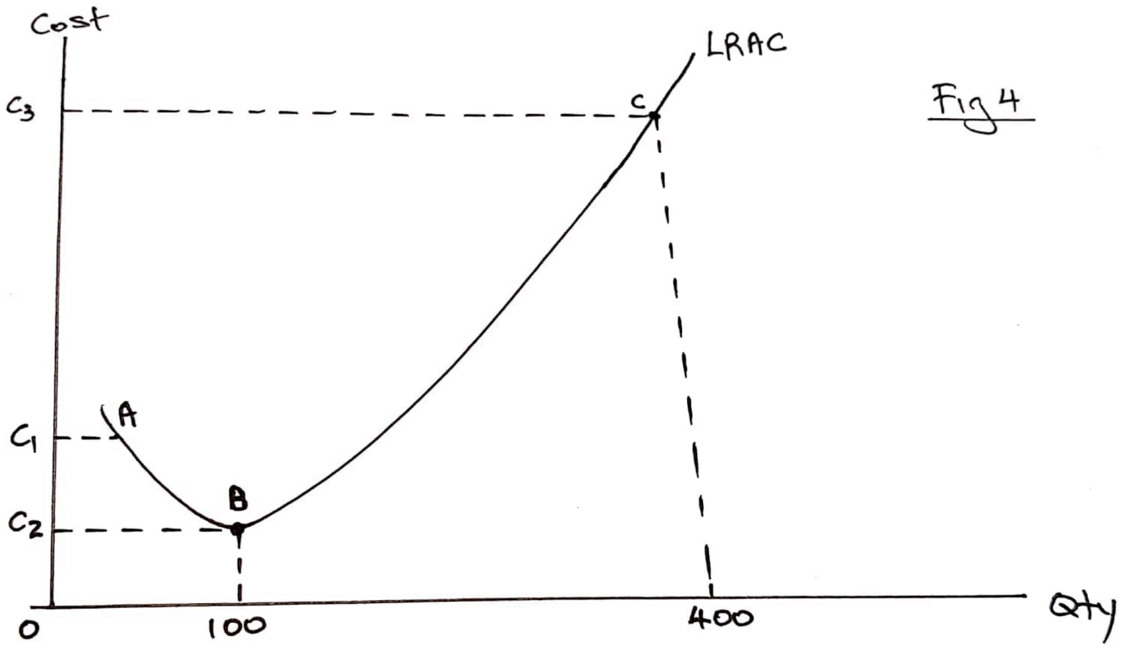
The combined effect of globalization would be a fall in price. But the effect on the firm's output is indeterminate. If incoming foreign rival firms are larger and more established (eg WalMart), then the local dominant firm (NTUC Fairprice supermarkets) will likely suffer a greater fall in demand, leading to lower output. If outsourcing results in much lower unit cost, then output will increase. Either way, consumers will be the ultimate beneficiaries from globalization.

B)

A firm can increase its size in various ways – through internal expansion, horizontal integration, diversification, etc. Price discrimination refers to the practice of charging different prices for the same product not on the basis of cost. Globalisation can facilitate a firm to increase in size as well as to discourage price discrimination.

Internal Expansion refers to a firm increasing its size by increasing its scale of production. Globalisation involves lowering of tariffs and other protectionist barriers between countries. This helps a firm to enter lucrative foreign markets especially consumption based economies with large domestic market eg USA. To meet this increased demand, the firm will increase its scale of production resulting in internal economies of scale. Hence globalization facilitates internal expansion of firms.

However, beyond a certain level of internal expansion, internal diseconomies of scale begin to set in. This may be due to miscommunication, increased bureaucracy and coordination problems across different departments within the larger firm. Ultimately, unit cost in the long run begins to rise, (instead of being reduced). This is especially for industries with low Minimum Efficient Scale (MES) eg firms dealing with highly specialized and personal services such as heart surgery clinics.



Internal EOS accrue only at a low output, up to 100 units (pt A to pt B) This is quickly followed by internal diseconomies (pt B to pt C), which raises unit cost from C_1 to C_2. For such firms, internal expansion is undesirable instead.

Horizontal Integration refers to a firm increasing its sze by acquiring / merging with other firms in the same industry at the same stage of production. Globalisation involves greater freedom of capital movement and investment. As such, globalization enables affirm to increase a firm to increase its size by acquiring profitable foreign firms in growing foreign markets. The firm immediately gains a significant mkt share in the foreign mkt and is able to expand further in future. For firms with mature, saturated domestic mkts, horizontal integration (internationally) may be a preferred strategy for expansion eg Singtel's (Spore) acquisition of Optus (Australia) and Bharti Group (India).

However, the govt may not approve the acquisition of certain local firms by foreign companies eg US govt blocked the purchase of US semiconductor firms by

Huawei on basis of national security. Hence, such actions may hinder a firm's horizontal integration expansion across countries.

A firm can increase its size through **diversification-** acquiring other firms in different unrelated industries. Globalisation encourages diversification further by enabling firms to acquire a diversified range of other firms in foreign markets (instead of being restricted to the domestic market). This is so as to spread out the business risk ie if a particular business subsidiary fails, the diversified firm has other subsidiaries in other industries (and in other countries) to rely on eg Louis Vuitton (France) has diversified from its luxury handbags by acquiring Spore's Crystal Jade chain of Chinese restaurants as well as local shoe retailer Charles & Keith.

However, a major disadvantage of diversification is that the conglomerate firm may be distracted by the wide range of business concerns. It may lose focus of its primary core business and miss important consumer trends eg SONY diversified into music and movie/television and missed the important MP# and handphone trends. Hence, even with globalization, some firms may still prefer not to expand/ diversify but to focus on their core business instead eg McDonald's fastfood restaurants.

Price discrimination refers to charging different prices for the same product, not on the basis of cost. To do so, the firm must have strong mkt power ie able to set prices. There must be effective mkt separation between the high and low priced mkts and No resale possible between mkts. Lastly, there must be different PED between the mkts.

With spread of technology through globalisaton, developing countries now also have access to e-commerce. This causes mkt seepage. If the pharmaceutical firm practices price discrimination globally, consumers in the low priced mkt (eg Myanmar) may resell the cheaper drugs through e-commerce to consumers in the high priced developed countries (eg USA). If such mkt seepage becomes prevalent, the pharmaceutical firm will eventually no longer be able to price discriminate across countries, even at the behest of the World Health Organisation.

However, the dominant pharmaceutical firm may still be able to minimize such mkt seepage through different branding/ different packaging / different strength level for the same drug. Thus, the firm may still be able to price discriminate globally.

In conclusion, globalization will encourage firms' expansion but discourage price discrimination up to a certain extent. However, with rising protectionism globally, there will be less opportunities for firms to expand and price discriminate across countries.

==================The End============================