Monopsony Power in Product Markets

Monopsony is an important idea in economics but not often discussed in the media – indeed there were only six references to it in the Financial Times between 2003 and 2008! But for economists wanting to understand changes in the balance of power between buyers and sellers in different markets and how this affects prices, profit margins and incentives, it is important to have an understanding of monopsony and its effects. At A2 level you will not be expected to use diagrams to show the impact of monopsony power in product markets.

What is monopsony power?

A monopsonist has buying power in their market. This buying power means that a monopsonist can exploit their bargaining power with a supplier to negotiate lower prices. The reduced costs of purchasing inputs increases their potential profit margins. Monopsony exists in both product and labour markets – in this chapter we focus on buying power in the markets for goods and services.

Examples of industries where monopsony power exists and persists:

1. The ability of the electricity generators to negotiate lower prices when negotiating coal and gas supply contracts'
2. The major food retailers have power when purchasing supplies from meat and poultry farmers, milk producers, wine growers and other suppliers. Given that the four major supermarkets now dominate the industry (namely Tesco, Sainsbury, Wal-Mart-Asda and Cooperative-Somerfield) I t might be more accurate to describe them as having **oligopsony power** when it comes to purchasing products from businesses at earlier stages of the supply-chain.
3. A car-rental firm seeking a contract to a car manufacturer to supply thousands of new cars for their fleet
4. Low-cost airlines reaping the benefits of monopsony power when purchasing a new fleet of aircraft
5. British Sugar buys almost the entire sugar beet crop produced in the UK year
6. Amazon's buying power in the retail book market – it gets a better price than other booksellers and this gives it a significant competitive advantage.
7. The increasing buying power of countries – for example China – in securing deals to buy mineral deposits from other countries – often in less developed nations in Africa.
8. The government is a major buyer e.g. in military procurement – and might be able to use this bargaining power when confirming contracts for new military equipment and supplies.

Case Studies on Monopsony Power

Dividing the spoils in the milk industry

"Supermarkets use their gigantic size and bargaining power to capture almost all of the profit from the milk industry, leaving farmers with a tiny proportion of the total: equal to only half a pence for each litre of milk." That is the central finding of new research by Drs Howard Smith and John Thanassoulis presented at the Royal Economic Society's 2008 annual conference. Farmers are in the weakest position, only able to secure 0.5 pence per litre, or about 3% of the total supply chain profits from liquid milk."

The research suggests that dairy farmers might help to counter-balance the power of the supermarkets by strengthening farmers' cooperatives. This is already happening in many parts of the country. But fundamentally the retailers will always hold the whip hand in pricing negotiations and contract agreements. The danger is that the market failure due to excessive monopsony power will lead to many more milk farmers leaving the industry, thereby increasing the demand for imported milk.

Is the buying power of dairies such as Robert Wiseman and Dairy Crest, who then sell much of their processed milk to large supermarkets such as Tesco and Asda, resulting in a fair deal for the small scale dairy farmer – the price taker? When a market has a sole buyer, a monopsony, prices are depressed by the buying power of the only outlet for the producers. Arguably the dairy farmer has lost out to the combined buying power of the dairies and the supermarkets.

Source: Tutor2u Economics Blog, March 2008 and Robert Nutter, EconoMax, November 2006

Halfords and their relationships with suppliers

In late 2005 allegations of abuse of buying power were directed at the UK bike and car accessory retailer Halfords. Halfords, with over 400 retail outlets, are twelve times larger than their nearest rival and thus suppliers rely strongly on their custom. In December 2005 it was reported in the financial press that Halfords were changing the terms of their agreements with suppliers. In particular Halfords allegedly told their suppliers that that would be paid in 120 days not 90 days as had been the practice since 2003, before which it was 30 days. Halfords would benefit by an extra £53.2 million - almost twice the capital spending by the firm for the period. In addition Halfords allegedly demanded a 5% across the range cut in prices and a bigger contribution to the company's advertising spend by suppliers. The key issue is whether Halfords' actions restrict, distort or prevent competition. Has the balance of power in the market shifted too much in favour of the buyer causing an unfair fall in prices and profits for sellers?

Source: Robert Nutter, EconoMax, February 2006

Monopsony power is often given a bad press! We read of 'greedy supermarkets' abusing their buying power to force down profit margins for suppliers and enjoy higher returns for themselves. In evaluation it is important to remember some of the possible advantages from monopsony power:

1. Improved value for money – for example the UK national health service can use its bargaining power to drive down the prices of routine drugs used in NHS treatments and ultimately this means that cost savings allow for more treatments within the NHS budget
2. Producer surplus has a value as well as consumer surplus – lower input costs will raise profitability which might be used to fund capital investment and research
3. A monopsonist can act as a useful counter-weight to the selling power of a monopolist
4. In most supply chain relationships – for example between supermarkets and their suppliers – the long term sustainability of an industry requires that both benefit – if there are no mutually beneficial gains from trade, ultimately trade and exchange will break down.
5. The growth of the Fair Trade label and organisation is evidence of how pressure from consumers can lead to improved contracts and prices for farmers in developing countries.

Suggestions for further reading on the economics of monopsony power

Barack Obama and John McCain go to war with Big Pharma (The Times, July 2008)

Bookstores – clubbing together to beat the big boys (BBC news, July 2008)

Milk prices report sparks call for fair trade rules in UK (Wales online, March 2008)

Supermarket powers to be curbed (BBC news, February 2008)

Tate and Lyle sugar to be FairTrade (BBC news, February 2008)

Tesco to pay dairy farmers more (BBC news, April 2007)