Chapter 15 Economies & diseconomies of scale

REALWORLD ECONOMICS 15.1
(p. 158)

Discussion point: Main economies of scale are:

- Internal economies – low capital costs per unit shipped; low labour costs because a crew of only 13 is needed; low fuel costs in relation to units carried; lower insurance and admin costs. Also high capacity utilisation of 85% brings cost savings.
- Internal diseconomies – the recession is lowering trade and so high fixed costs are being spent on smaller loads of cargo; exports from Europe to Asia always work on lower capacity (55%) than the journeys from Asia to Europe.
- External economies – the industry adopted a system of containerisation, which allows greater integration between road, rail and water transport and leads to lower costs for all firms in the industry.
- External diseconomies of scale – low capacity utilisation in the industry as a whole is likely to increase average costs. The most cost-effective container ships are not compatible with the facilities provided in some countries (e.g. New Zealand) and on some routes (e.g. the Panama Canal).

This industry is very competitive and heavily dependent on the level of worldwide trade. All shipping companies therefore operate in a high-risk industry. This risk is intensified by high levels of spare capacity, which is encouraging fierce competition for business. However, the highest risk is faced by smaller competitors, which are likely to be pushed out of the market by Maersk's high level of economies of scale – hence Maersk may be less at risk than other firms.

Review questions
(pp. 158–259)

1 A *(1 mark)*

2 D *(1 mark)*

3 A *(1 mark)*

4 B *(1 mark)*

5 D *(1 mark)*

6 B *(1 mark)*

7 C *(1 mark)*

8 Close proximity to suppliers is a possible cause. This enables the firm to reduce the costs of transport and also benefit from flexibility of a local supplier. *(4 marks)*

9 Internal economies of scale are the advantages that a firm gains due to an increase in its size. External economies of scale are the advantages that a firm gains due to growth in the size of the industry within which it operates. Both types of economy lead to lower average costs. *(6 marks)*

10 Two possible causes of internal economies of scale are:

- Technical economies of scale. Large firms can use more expensive capital equipment and use employee specialisation and division of labour to a greater extent. These factors will enable larger firms to produce more efficiently and so lower their average costs of production.
- Since it is cheaper to produce in bulk, suppliers will offer raw materials to large firms at lower prices because a bulk order is cheaper to produce. Furthermore, large firms can use their scale to improve their bargaining power, forcing suppliers to offer lower prices. *(8 marks)*