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When the leaders of media, telecommunications, IT and internet companies congregate, as they did recently in Davos, the talk is upbeat about new accomplishments but subdued about recent ordeals: the dotcom bubble; the telecoms crash; the music industry bust; the advertising downturn; the e-publishing revenue stagnation; the PC slowdown; the wireless saturation; the semiconductor slump; the newspaper recession; the R&D retrenchment. And the question is, why do these predicaments sweep over the information sector so regularly?

The prevalence of these problems points to fundamental issues beyond a specific industry or short-term period. Instead, we need to recognise that the entire information sector - from music to newspapers to telecoms to internet to semiconductors and anything in-between - has become subject to a gigantic market failure in slow motion. A market failure exists when market prices cannot reach a self-sustaining equilibrium. The market failure of the entire information sector is one of the fundamental trends of our time, with far-reaching long-term effects, and it is happening right in front of our eyes.

The basic structural reason for this problem is that information products are characterised by high fixed costs and low marginal costs. They are expensive to produce but cheap to reproduce and distribute, and therefore exhibit strong economies of scale with incentives to an over-supply. Second, more information products are continuously being offered to users. And information products and services are becoming more "commodified", open, and competitive.

The main result of these factors is that prices for content, network distribution and equipment are collapsing across a broad front. It seems to have become difficult to charge anything for information products and services. The music industry is unable to maintain prices. Online publishers cannot charge their readers, except for a few premium providers such as the FT. International phone call prices have dropped, and with internet telephony will move to near-zero. Web advertising prices have collapsed. Much of world and national news is provided for free. A lot of software is distributed or acquired gratis. Academic articles are being distributed online for free. TV and radio have always been free unless taxed. Even cable TV, at 20,000 programme hours a week, is available to viewers at a cost of a 1/10 of 1 cent per hour. Newspaper prices barely cover the physical cost of paper and delivery; the content is thrown in for free.

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All these are symptoms of a chronic price deflation that shows no sign of abating. It is a good deal for consumers, including those of developing countries, but it spells disaster for providers. The price for their information or distribution is dropping towards marginal cost, which is close to zero and typically does not cover full cost. No company can afford to do this for long. And the more efficient the information market becomes due to technology, the faster this process advances.

And there is more trouble ahead.

First, the various sub-industries of the information sector affect each other more, and faster, than ever before. For example, the excess availability of banner ads leads to the collapse of the business model for many websites, which in turn harms tech magazines, telecoms networks, internet backbones, equipment makers and R&D.

Second, the information industries will go through boom-bust cycles, of which we have merely experienced the first. The reaction of information sector companies to the price declines is to cut costs, outsource, hedge, diversify and use new processes such as micropayments. They will try to innovate to differentiate their products. But there is a limit to the ability of individuals and organisations to absorb rapid change over a sustained period. Therefore, the main strategy will be to consolidate and cartelise in order to maintain pricing power. As a result, prices and profits rise (as well as media concentration), which will lead again to expansion, entry, and by the same economic logic, to a new price collapse, with a general downward trend in prices. Those fluctuations are then exacerbated through credit cycles triggered by the drop in equity prices. Third, the price deflation oscillating through the information sector will drag down the rest of the economy, too, through a multiplier effect.

The conclusion is, therefore, that as countries rely more on information-based activities, their economies become more volatile.

If that is the case, what are the policy implications? Volunteerist activities such as open-source software, shared information or public hotspots will not solve the problem, because they, too, are subject to the instability known as the "tragedy of the commons", in which individuals' free-loading and over-utilisation destroys the communal effort. Therefore, governments will inevitably be drawn into the business of stabilisation. But this is easier said than done. Classic approaches such as Keynesian demand stimulation, or monetary policy or industrial strategy do not address the core problem of the information sector. That problem is not inadequate demand or investment, but

over-supply, competition and structural price deflation.

Perhaps the most effective thing that government can do instead of interfering in the information sector is to help diversify the economy to a more balanced portfolio. This means encouraging manufacturing industries that are not closely correlated with the health of the information sector, often low-tech industries. Such a policy would represent quite a reversal from the past, when every country wanted to develop into an information society. But the success of such a strategy exposes the entire national economy to a greater volatility and disruption. Take Finland. Nokia accounts for 35 per cent of all exports and 15 per cent of GDP, including its secondary impacts. So imagine if the wireless business turns weak. A whole country is at risk, not just a single company.

Thus, the information economy is likely to be a volatile, cyclical, unstable mess. The problem is not the "creative destruction" one would expect in an innovative economy, but the structural instability of an economy whose major products have very low marginal costs and hence prices, but are not low-cost to produce. The notion that an information-based economy will be inherently prosperous must be revised for a less optimistic scenario.

But this conclusion might at least enable us to think ahead and contemplate private and public strategies. That would be better than following the hype of previous years, which has led the information industries to their present crisis. It will not be their last.

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